

AUDITING BANKS: RELATIONSHIP BETWEEN ISSUES CITED IN MODIFIED OPINION, EMPHASIS AND KAM

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ABSTRACT

The purpose of this study was to verify the relationship between the topics cited as a basis for modified opinion, emphasis paragraphs and the key audit matters (KAM) in the audit work carried out in Brazilian banks. Using the content analysis technique, the reports issued by the auditors on the statements of 134 Brazilian banking institutions, from 2007 to 2016, were examined, totaling 746 reports. The results of the examinations revealed that the topics related to deferred tax assets, provisions and actuarial passive issues are directly associated among those used as basis for modified opinion, emphasis paragraph and KAM. Operational continuity is prominent for both modified opinion and emphasis, but not as KAM. Asymmetric behavior is highlighted in the most cited issues for modified opinion (leasing) and KAM (provision for losses on credit operations), which have little relevance in the other topics. The research contributes to the development of the national literature on auditing, insofar as it assesses the association between the issues that have received more attention of the independent auditors in the preparation of their reports on the Brazilian banks' statements, whether as a modification of opinion, emphasis or KAM – an approach not yet explored in the literature on the subject.

Keywords: Audit. Audit Report. Modified Opinion. Emphasis. KAM.

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1 INTRODUCTION

Banking institutions play a crucial role in countries' economy since they act as intermediaries for resources supply and demand. To perform these functions safely, banks work based on trust. In this context, independent auditors' opinions provide credibility to financial statements, thus contributing to the banking system reliability, as highlighted by the *Basel Committee on Banking Supervision* (BCBS, 2002). However, major corporate scandals that occurred in the early part of this century have been directly linked to accounting manipulation and fraud practices and had not obtained any modified opinion from independent auditors, in addition to cases where audit companies themselves would be involved in frauds. These facts have placed audit companies and the scope of auditors' responsibilities in the spotlight (Dantas and Medeiros, 2015).

The financial crisis of 2007–2008 (also known as the global financial crisis and the 2008 financial crisis), triggered by a succession of bankruptcies of financial institutions in the United States of America and countries in Europe, has reinforced investors' and stakeholders' concerns, who demanded more credibility in the market with respect to financial information disclosed by companies (Gold, Gronewold and Pott, 2012). Disclosures in reports from companies involved in the global crisis were not compatible with their economic realities and this situation has generated some skepticism about corporate reporting, including audit reports (PwC, 2016; Giroto, 2016).

Audit opinions economic effect repercussion, with a proviso or an emphasis paragraphs, may indicate, for example, possible discontinuity of some company's operations, making clear, to anyone interested in the information, the uncertainty about their investments and, consequently, this may affect the allocation of investors' financial resources. In this context, predicting or explaining audit reports with a proviso or an emphasis paragraph may have implications for information users (Sparthis, 2003 as mentioned in Damascena and Paulo, 2013).

Also in this context, professional standards should be up-to-date in order to improve audit processes and give more reliability to financial statements. Regulators, in order to improve auditors' actions, have implemented normative innovations such as the *Clarity Project* established from 2004 by the *International Auditing and Assurance Standards Board* (IAASB), sponsored by the *International Federation of Accountants* (IFAC) and the objective of developing and implementing a set of professional standards that ensures the development of high-quality assurance work and objectively defining independent auditors' responsibilities. As a result, 36 *International Standards of Auditing* (ISAs) have been issued with effect from 2010, which in Brazil have been received in the form of Brazilian Independent Accounting Audit Standards (NBC-TA).

Audit report standards have accountability paragraphs – from management and independent auditors – which more clearly delineate each agent's performance and responsibilities involved in financial disclosure processes. Emphasis and other topics paragraphs are characterized as prerogatives to be used by auditors. Regarding types of opinion, audit reports may be presented as: (i) reports without modification when auditors conclude that financial statements have been prepared, in all material respects, in accordance with the applicable financial reporting framework or (ii) amended reports in cases where auditors conclude that the statements taken together present material misstatements or when they are unable to obtain audit evidence that is appropriate and sufficient to form a conclusive opinion on the information reliability. An opinion is not to be confused with modification and emphasis paragraphs that are used by auditors to draw users' attention to aspects that are relevant to understanding financial statements should be presented (Castro, Vasconcelos and Dantas, 2017; Damascena and Paulo, 2013).

In the last change in auditing standards in 2016, the IAASB issued and amended the ISAs with the purpose of promoting changes in audit reports for listed companies. Inclusion of Key Audit Matters (PAA, in the Brazilian Portuguese abbreviation) has been the main change in the

report, as it makes the document more informative, besides addressing what has been considered relevant in audit works. Therefore, some relevant expectation has been created on topics that would be approached as PAA.

Considering this context, the research question is: Is there a relationship among topics used to modify opinions, develop emphasis paragraphs, and define PAA in audit reports on Brazilian banks' financial statements?

The assumption is that there is an association among subjects used in the three topics because they reflect issues that are more relevant to understanding statements (emphasis), present items of greater concern in the development of audit work (PAA) and represent aspects that are more topic to financial information (modified opinions) material misstatement.

Thus, in analyzing audit work carried out in the Brazilian banking industry, the purpose of this study is to evaluate the relationship among the following topics: (i) indicated as justifications for modification of auditors' opinions; (ii) dealt with in the emphasis paragraphs and (iii) defined as PAA. In order to achieve this objective, using the Content Analysis technique, 746 reports issued by independent auditors on financial statements from Brazilian banks over a 10-year period between 2007 and 2016 have been examined, focusing analyses of reasons highlighted by auditors to justify change of opinions, to develop emphasis paragraphs and to communicate the PAA, seeking to identify if there is a relationship among them.

The research contributes to the development of the national literature on auditing insofar as it assesses the association among topics that have received the most attention from independent auditors in preparation of their reports on Brazilian banks' statements, whether as modifying opinions, emphasis, or PAA – an approach that can be considered as incipient in the literature on the topic.

2 THEORETICAL FRAMEWORK

2.1 The role of the audit

For the *Public Company Accounting Oversight Board* (PCAOB, 2002), an audit aims to increase financial statements degree of trust. This is achieved by opinions issued in independent auditors' reports, in which they assess whether financial statements are in conformity with applicable financial reporting frameworks, i.e., accounting standards established by regulatory bodies.

The *International Federation of Accountants* (IFAC, 2012) considers that audit should convey to financial statements users some reasonable assurance obtained by auditors and that statements be free from material misstatement, whether by mistake or even fraud, even if it is not the auditors' objective to find them. In this context, independent auditing is recognized as an important monitoring tool to regulate conflicts of interest and reduce agency costs (Jensen and Meckling, 1976; Pereira, Machado and Pinheiro, 2017).

Múrcia, Borba and Schiehl (2008) emphasize that auditors need to base their opinions on verifiable evidence. Based on such evidence, independent auditors should express opinions on the veracity of information contained in financial statements in accordance with generally accepted accounting principles.

Discussions on auditors' responsibilities have been in the spotlight even after the new governance models proposed after the (former American energy, commodities, and services company based in Houston, Texas) Enron Corporation crisis, that is, the audit market continues to face questions about its effectiveness and credibility (Dantas and Medeiros, 2015). Some regulatory agencies have reacted by implementing regulatory laws such as the Sarbanes-Oxley Act, which has been created in 2002 in the United States to restore accounting information credibility, increasing the cost of litigation and the level of corporate governance (Mendonça, Costa, Galdi and Funchal, 2010). Given that financial institutions depend on credibility, auditors'

reports are important pieces in the process of market reliability vis-à-vis these entities.

2.2 Audit in banking institutions

Banks are private or public financial institutions, the main objective of which is to provide the necessary resources to finance, in the short and medium terms, trade, industry, service providers and individuals. Banks activities are related to risk, since in the process of financial intermediation they promote deadlines transformation, incurring credit, market and liquidity risks. For this reason, trust and credibility are of paramount importance for financial institutions (Dantas and Medeiros, 2015), identifying an objective relationship with the work carried out by independent auditors, which is to add trust and credibility to information disclosed by entities by means of financial statements.

According to Gallo and Nicolini (2002) and Pereira (2006), due to new market pressures and financial scandals in recent years, it has become necessary to convince banks at the global level to have an information system in the area of risk in order to manage it efficiently. For this reason, the BCBS was created, the mission of which is to coordinate and formulate guidelines formalized by means of the so-called Basel Accords, which aim to create minimum capital requirements for financial institutions as a way of addressing the risks to which the system is exposed. These regulatory provisions, particularly as regards capital requirements, do not replace or reduce the importance of audit work for creation of an environment characterized by trust, credibility and stability. An expression in this sense is presented by the BCBS itself (2002).

For Kanagaretnam, Krishnan and Lobo (2010), audit studies in financial institutions are not common due to their peculiarities, in relation to either assets or operations and requirements of regulatory bodies. The authors point out that the evidence obtained in other segments does not necessarily repeat itself in the banking system, precisely because of the fact that banks operate in a highly regulated environments monitored by central banks and/or other regulatory agencies.

As reported by Dantas and Medeiros (2015), due to the financial crisis of 2007–2008, where several companies have gone bankrupt, discussions about the expectations gap in relation to auditors' liability limits have been accentuated due to investigations carried out on audit companies' failure to warn about the risks that led to the bank crisis.

2.3 Key Audit Matters (PAA)

With the ISAs amendments in 2016, independent auditors' report standards include ISA 701 – *Communicating Key Audit Matters in the Independent Auditor's Report*. In Brazil, this standard has been approved as NBC TA 701. It deals with auditors' responsibility to communicate which PAA have been considered in their work, that is, to address auditors' judgment about what to state on their reports and also such communication form and content. This standard applies to audits performed on listed entities – with stock or debt securities traded on the stock exchange.

Communication of PAA aims to make the report more informative, adding more transparency to audits carried out. Presentation of these topics provides additional information to statements users, helping them to better understand what auditors have considered relevant in the audit, and to help understand the entity and the areas that have involved significant judgment in financial statements preparation. These are topics that, according to auditors' professional judgment, have been the most significant ones in auditing the current period's statements, being selected among those communicated to those responsible for governance, that is, those that required significant attention by auditors during the course of their work (PwC, 2016). Audit reports should contain a specific section entitled "Key audit issues" and auditors should describe each topic using appropriate subheadings. Descriptions should contain the reason why the topic has been considered significant and how it has been handled in the audit.

It is thus perceived that updating the audit report has begun with a desire for more information from investors. Even if the change has not translated into changes in the scope of

audit work, it represents greater commitment on the part of auditors in preparing the report, in addition to providing greater transparency and trust.

2.4 Previous research

In Brazil, some studies have already dealt with audit reports content regarding modification of opinions, use of emphasis paragraphs and PAA, according to studies presented on this topic. The innovation of the present study is in evaluating the association among the topics addressed in the three situations.

a) On changing opinions

Among studies carried out in Brazil on audit reports with modification of opinion it is possible to highlight: Santos (2008), Silvestre, Sprenger and Kronbauer (2016), Spathis (2003), Peres and Peters (2017), Castro *et al.* (2017), Patrocínio, Coutinho, Reina and Reina (2017), among others.

Santos (2008), for example, has found that in financial institutions the management is more likely to change the auditing company when receiving an opinion modified by provisos and relevant emphasis than when obtaining a clear opinion from the current audit company. Identification of the main reasons that have led to issuance of a modified audit report of companies listed in B3 [(in full, B3 – Brasil Bolsa Balcão S.A.), formerly BM&FBOVESPA, a stock exchange located at São Paulo, Brazil] in the pre- and post-convergence periods of Brazilian standards to international accounting standards has been an object of study by Silvestre *et al.* (2016). Examinations of reports modified views from the pre-convergence period to the standards, 2004 to 2007, have shown that predominant motives for modified opinions have been mainly investments and taxes. In the period from 2010 to 2013, post-convergence, predominant topics for modified opinions have been investments and operational continuity.

For Spathis (2003), amended opinions economic effects repercussion may indicate companies' possible discontinuity of operations, making clear to those interested in the information the uncertainty about their investments and therefore this may affect the allocation of investors' financial resources. Peres and Peters (2017) have identified that of 613 companies listed in Brazil, 40 have submitted independent auditors' reports on 2015 financial statements with modification and 70% of these companies have exchanged some members of their management staff.

Evaluation of impacts of adopting ISAs on auditors' opinion on Brazilian banks financial statements has been explored by Castro *et al.* (2017). The evaluation has been carried out in 478 reports between 2006 and 2013 and it has been found that there has been an increase in the frequency of reports with opinion modification but that has not been statistically relevant. In relation to the most approached topics to justify modified opinions, reclassification of commercial leasing operations, misappropriation of revenues and expenses and actuarial matters should be highlighted.

Patrocínio *et al.* (2017) have had the purpose of identifying reasons for proviso or emphasis paragraphs in auditors' reports issued from 2010 to 2015 for entities listed in the B3 so-called Novo Mercado (New Market), noting that there was an increase in issuance of reports by auditors with proviso or refraining from opinion due to adoption of international accounting standards, showing that entities have faced difficulties in complying with international standards.

b) On emphasis paragraphs

Concerning studies on audit reports with emphasis paragraphs, it is possible to highlight, by way of examples, Damascena and Paulo (2013), Castro *et al.* (2017) and Patrocínio *et al.* (2017).

Damascena and Paulo (2013) have verified in their research that accounting variables and economic-financial indicators have an influence on the issuance of audit opinions with proviso or emphasis paragraphs in B3 companies, noting that the higher the company's value, the lower the

chance of an emphasis paragraph being presented. The study by Castro *et al.* (2017), focusing on assessing the impacts of adopting ISAs on audit reports on Brazilian banks' financial statements, has also mapped the main causes for the presentation of emphasis paragraphs, noting that tax credits were the main topic highlighted by auditors.

It is also necessary to emphasize the study by Patrocínio *et al.* (2017), which has found that the criterion adopted for investments equity valuation has been the main reason for issuance of emphasis paragraphs in audit reports on statements from companies listed in the B3 Novo Mercado segment from 2010 to 2015, showing that companies would not be adopting the criteria established by accounting standards.

c) On the Key Audit Matters (PAA)

Regarding the use of PAA, Rocha (2016) notes that the first country to adopt the new audit report was the United Kingdom in 2013, before it even had a specific standard. Then the Netherlands followed the same path and in 2014, along with other countries, Austria, Poland, Switzerland, Germany and Zimbabwe began to adopt the new format.

In the United Kingdom, two studies by the *Financial Reporting Council* (FRC) have been carried out on the experience of the new audit report, with the first two years being analyzed and the first study being based on 2014 reports (FRC, 2015) and the second being based on the 2015 reports (FRC, 2016).

In the first year, the FRC (2015) concluded that in most cases auditors made changes to audit reports that exceeded the changes required by the FRC, i.e., reports contained more information than had been requested. The survey specific conclusion was that each of the audit companies adopted different approaches to the report. The FRC (2015) considered very encouraging the degree of innovation and the diversity of approaches adopted. Changes have been found in the following areas: disclosure of the materiality used, communication to the Audit Committee on topics considered significant, identification of risks, broader and detailed explanation of the audit process and improved presentation of audit reports using figures. In addition to addressing the strengths, the FRC study presented points that needed to be improved, such as clearer explanations of risks and materiality and how they have influenced audit work. Thus, the experience was positive, allowing auditors to be more specific in their reports, and the description of the PAA made these documents more informative and transparent for users, especially investors.

The main conclusions about the second year study (FRC, 2016) were: improvement in the language used by independent auditors, aimed at the end user, leaving aside the use of generic terms, mainly with more accurate descriptions about risks and the incorporation of more information about materiality and description of areas where professional judgment was most relevant. It is important to note that the FRC realized that some points of the new report need to be improved, such as auditors' assessment of the quality of entities' internal controls and auditors' view of the adequacy of management estimates, besides having missed communication regarding changes in audit approaches as in the level of materiality that was used.

Another research with this focus was carried out by Bédard, Besacier and Schatt (2014), which analyzed the effect of PAA on abnormal returns, results management and audit fees. As the outcome has not presented statistically significant results, the authors concluded that the PAA have a symbolic effect but reinforce that different institutional environments may present different results.

Christensen, Glover and Wolfe (2014) have conducted experiments with 141 nonprofessional investors but who had been trained in business schools. Results showed that the PAA affect the investment decision since investors exposed to audit reports with PAA tended to change their decision in greater proportion. On the other hand, it was found that when PAA solutions were presented, the decision was maintained, which indicates that resolutions proposed for problems reported increase investors' trust. Marques and Souza (2017) have sought to identify and analyze the PAA informed in auditors' reports for companies making up the

Brazilian Bovespa Index (best known as Ibovespa) in 2016, where the PAA reported were on asset recovery, contingencies, revenue recognition and projection of future results for realization of assets.

In Brazil, the Instituto dos Auditores Independentes do Brasil (Institute of Independent Auditors of Brazil)(Ibracon, 2017) presented a study that analyzed the section of PAA of 546 publicly-held companies, including the 100 largest listed companies, not considering investment funds. In the survey, it was observed that in 32% of the reports analyzed were considered as the Main Audit Topic the recoverable amount of non-financial assets (impairment) since it involved subjective assumptions and judgments. Revenue recognition was the second most found PAA in the reports, showing concern about contracts specificities.

This study focuses banking institutions while in the study made by Ibracon companies from B3 various sectors were considered. This narrower focus makes it possible to analyze in detail the PAA found in bank reports and thus to infer the implications of the new audit report in this market, which presents very particular characteristics, including regulatory aspects. It should also be noted that this study is not restricted to listed entities, reaching all types of corporate arrangements and structures.

3 METHODOLOGICAL PROCEDURES

The purpose of this study is to verify the relationship among the topics (i) indicated as justifications for alteration of auditors' opinions, (ii) discussed in the emphasis paragraphs and (iii) defined as PAA in independent auditors' reports on Brazilian banks' financial statements. To achieve this purpose, methodological procedures described in Steps 1 to 5 have been applied, with emphasis on the use of Content Analysis (Bardin, 2010).

Content Analysis has been performed in audit reports on financial statements from sample companies, identifying items of opinion modification, emphasis paragraph or PAA, i.e., which topics were approached to justify each of these positions by independent auditors. Analysis of the items was structured as follows: (i) Pre-analysis, described in Steps 1 and 2; (ii) preliminary exploration of items to be analyzed, described in Step 3; (iii) handling the results, inference and classification, described in Steps 4 and 5.

Step 1: Selecting the banks object of the study

The research sample is the financial statements of 134 conglomerates or individual banking institutions that are not part of conglomerates operating in the Brazilian market as of December/2016, according to the IF report. Date published by the Central Bank of Brazil (BCB) on its website.

Step 2: Location of the sample selected banks' financial statements

The analysis comprised financial statements for the period from 2007 to 2016 by means of consultation of the selected banks' websites in Step 1. Also researched were the web sites of Brazilian Securities and Exchange Commission (Comissão de Valores Mobiliários – CVM) and FEBRABAN (Portuguese abbreviation for the Brazilian Federation of Banks). 746 audit reports on these institutions' financial statements have been found and analyzed, annually distributed according to Table 1. As can be seen, the more recent the base date, the greater the number of localized demonstrations.

Step 3: Identification of audit reports with change of opinion, emphasis paragraph or PAA

The 746 audit reports collected in the previous step were examined and it was observed that 88 presented a change of opinion, 140 presented an emphasis paragraph and 31, PAA – corresponding to 11.8%, 18.8% and 4.2% of the total of the reports examined, respectively. Table 1 demonstrates the temporal composition of these events, with the exception of the fact that the PAA only appear in the last research year (2016) when the NBC-TA 701 was in force.

Table 1
Number of audit reports analyzed each year

Fiscal Year	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	Total
No. of reports	48	52	58	64	72	78	82	82	92	117	746
Opinion with modification	4	4	3	5	10	9	12	14	12	15	88
Emphasis paragraph	9	9	9	11	13	16	15	18	22	18	140
PAA	0	0	0	0	0	0	0	0	0	31	31

Step 4: Mapping of topics covered for opinion change, emphasis paragraph or PAA

Using the Content Analysis technique, the opinion modification reports, emphasis paragraph and PAA highlighted in the previous step have been examined in order to identify which topics have been approached to justify each of these positions by the independent auditors. From this mapping, the most frequently topics used by independent auditors to modify opinion, to present as an emphasis or to highlight as PAA have been analyzed, trying to identify the reasons that would justify some possible concentration on certain topics.

Step 5: Analysis of the relationship among topics used for opinion modification, emphasis paragraph and PAA

In order to identify if there is an association among the most used topics in each one of those addressed in the present study, a graphic analysis was developed associating the topics: (i) used as justification for opinion modification versus presented as emphasis; (ii) presented as emphasis versus highlighted as PAA and (iii) used as justification for changing opinions versus highlighted as PAA.

4 RESULTS ANALYSIS

With reference to the procedures outlined in Section 3, the contents of 88 audit reports with modified opinions, of 140 with emphasis paragraphs and of 31 with PAA have been examined, according to Table 1. The purpose is, by means of the Content Analysis technique, to categorize the topics used by independent auditors to justify each of the situations highlighted in the report.

From the mentioned identification of the most covered topics in the three types of reports – detailed in Subsections 4.1 to 4.3 – the topics were classified in alphabetical order, with a unified code: A1 – Technology environment; A2 – Commercial leasing; A3 – Capital and corporate operations; A4 – Operational continuity; A5 – Tax credits; A6 – Deferral of negative net income – Resolution 4036/11; A7 – Distortions in other comprehensive income; A8 – *Hedge accounting*; A9 – Nonrecognition of expenses; A10 – Standards and regulations; A11 – Credit operations; A12 – Estimated allowance for doubtful debtors (PECLD); A13 – Passive provisions; A14 – Actuarial matters; A15 – Misrepresentation of assets; A16 – Republishing information; A17 – Result of shareholdings; A18 – Fair value of financial instruments; A19 – Asset recoverable amount; A99 – Other topics.

4.1 Topics cited as justifications for a change of opinions

Examination of the 88 audit reports with modified opinions between 2007 and 2016 has revealed that for each of them a single event has been highlighted as justification, consolidating 88 events. Table 2 summarizes the mapping or categories of the most approached topics to modify auditors' opinions.

Table 2
Most cited topics as justifications for changing opinions in Brazilian banks' financial statements audit reports – 2007 a 2016

Code	Topics mentioned	Qty.	% Relat.	% Events
A2	Commercial leasing	17	19.3%	19.3%
A5	Tax credits	12	13.6%	13.6%
A6	Deferral of negative net income (Res. 4036/11)	11	12.5%	12.5%
A13	Passive provisions	9	10.2%	10.2%
A14	Actuarial matters	8	9.1%	9.1%
A4	Operational continuity	6	6.8%	6.8%
A7	Distortions in other comprehensive income	5	5.7%	5.7%
A9	Nonrecognition of expenses	5	5.7%	5.7%
	Other	15	17.0%	17.0%
Total reports		88		
Total Events		88		

The data show that problems related to commercial leasing operations represent the main topic that justifies auditors' modification of opinions on Brazilian banks' financial statements in the period from 2007 to 2016, representing 19.3% of the modified opinion cases in the period. This is due mainly to a divergence between what the rules established by the Brazilian banking regulator envisages as accounting practices and the guidelines indicated in the accounting model adopted in the capital market, which replicates, by means of a statement from the Brazilian Committee of Accounting Pronouncements (CPC in the Brazilian Portuguese abbreviation), the guidelines from the *International Financial Reporting Standards* (IFRS). For this reason, it is common for auditors to point out that financial statements are in accordance with the rules established by the regulator but that they contradict the accounting conceptual structure.

Tax credits have also been reported several times as justification for reservations, representing 13.6% of reports and cases of change of opinion. Arguments for this generally lie in the impossibility of confirming the prospect of realization of these assets within the ten-year regulatory deadline. In the case of questions related to deferral of negative net income, which represent 12.5% of the opinion change events, this is associated with the possibility established in CMN Resolution no. 4,036 of 2011 to defer the negative net result arising from renegotiation of previously assigned credit operation. Despite this regulatory capacity, auditors present a proviso in the statements in which this value is relevant since they contradict accounting conceptual precepts.

Questions about passive provisions, measurement of actuarial liabilities and distortions in other comprehensive income are other topics that are also relevant to auditors' opinion modification events, which are justified by the subjectivity implicit in the process of recognition and measurement of these equity items.

Finally, events related to entities' operational continuity are highlighted. The six events highlighted have involved Brazilian banks Ficsa and Maxima. For Ficsa the rationale for strategy revaluation has been determined and it decided to permanently suspend its credit operations and change the focus to management of its current portfolio in order to promote the institution's deleveraging. As for Máxima, the risk of insufficient margin to bear its operations risks was pointed out, which is characterized as one of the minimum required regulatory requirements defined by regulators' standards.

4.2 Topics mentioned in the emphasis paragraphs

The second block of analysis focuses on identifying the topics most frequently pointed out by auditors in Brazilian banks' statements audit reports emphasis paragraphs from 2007 to 2016. Results from this analysis are categorized in Table 3, emphasizing that the difference between report and event totals is justified by the fact that some reports present more than one topic in the emphasis paragraphs.

Table 3
Most cited topics in Brazilian banks' financial statements audit reports emphasis paragraphs – 2007 to 2016

Code	Topics mentioned	Qty.	% Relat.	% Events
A5	Tax credits	36	25.7%	23.8%
A13	Passive provisions	21	15.0%	13.9%
A3	Capital and corporate operations	18	12.9%	11.9%
A10	Standards and regulations	18	12.9%	11.9%
A14	Actuarial matters	17	12.1%	11.3%
A4	Operational continuity	16	11.4%	10.6%
A16	Republishing information	10	7.1%	6.6%
	Other	15	10.7%	9.9%
Total reports		140		
Total Events		151		

As summarized in Table 3, topics related to tax credits are the most addressed ones in emphasis paragraphs in the sample examined, being present in 25.7% of the audit reports with an emphasis paragraph and in 23.8% of all the highlighted events. These cases are related to recognized deferred tax assets but in respect of which auditors point out that they have been estimated by means of estimates that depend on future taxable income. Financial institutions with the highest occurrence of this situation were Brazilian Caixa Econômica Federal, Banco Pan, BRB, Banco Luso Brasileiro, Banco Semear and Banif.

Two other topics that are included in the list of those most cited to justify change in opinion also deserve attention among those mentioned in emphasis reports: passive provisions and actuarial matters. Much like tax credits, these are equity items for which there is a strong dose of subjectivity, which justifies auditors' concern in emphasizing this scenario without necessarily changing opinions regarding information presented by management.

Also in an equivalent way to that identified in cases of opinion change, operational continuity reports with only change of approach is also worth mentioning in emphasis paragraphs. In emphasis paragraphs, auditors' reports focus mainly on pointing to operational changes promoted by the institutions in order to preserve their operations continuity.

The major novelties of the topics addressed in the emphasis paragraphs, compared to those used to modify opinion, are those related to topics involving the level of regulatory capital and corporate operations – present in 12.9% of reports with emphasis – and compliance with standards and regulations – also highlighted in 12.9% of the reports, which contain emphasis paragraphs. Cases related to capital level and corporate changes are usually addressed when incorporating other banks, capital increase, transfer of share control and investments. As for standards and regulations, they are associated with banks that have not complied with regulatory standards in certain transactions.

Finally, the fact that 10.7% of reports with an emphasis paragraph report cases of republication of information stands out. It is typically a situation of emphasis, that is, when the

financial institution has republished information and auditors intend to emphasize to demonstrations users, for the purposes of that republication, which it was presented by the management.

4.3 Topics mentioned as Key Audit Matters (PAA)

The third block of analysis focuses on the analysis of the PAA highlighted by independent auditors in reports on financial statements for 2016. In this case, limitation to 2016 is justified by the fact that this was the year in which the NBC-TA 701 terms began to be in force, which established the forecast of incorporation of PAA to publicly held companies. Restriction to publicly held companies justifies the fact that only 31 of the 117 audit reports examined in 2016 present PAA.

Communication of PAA aims to make the report more informative, adding more transparency to the document. As discussed earlier, these topics are those that, according to auditors' professional judgment, were the most significant in auditing financial statements of the current period. Regarding topics that comprise the PAA in the 31 reports, these are summarized in Table 4 and it should be noted that 107 topics were cited, representing an average of 3.5 PAA for each report.

Table 4

Most cited topics as PAA in Brazilian banks' financial statements audit reports – 2016

Code	Topics mentioned	Qty.	% Relat	% Events
A12	Estimated allowance for doubtful debtors (PECLD)	27	87.1%	25.2%
A5	Tax credits	16	51.6%	15.0%
A13	Passive provisions	15	48.4%	14.0%
A1	Technology environment	14	45.2%	13.1%
A14	Actuarial matters	11	35.5%	10.3%
A18	Fair value of financial instruments	9	29.0%	8.4%
A19	Assets impairment	6	19.4%	5.6%
A11	Credit operations	5	16.1%	4.7%
	Other	4	12.9%	3.7%
Total reports		31		
Total Events		107		

The type of PAA most found in the reports refers to the estimated provision for doubtful debtors (PECLD), which accounts for 87% of the reports with PAA and represents 25.2% of all outstanding topics. Analysis of arguments used by independent auditors to consider this as one of the PAA reveals, among others, the following justifications: relevance of the credit operations balance, guarantees received for credit operations granted, the country's economic situation and the management judgment applied in estimation of the provision. This is coherent with a statement by Kanagaretnam, Krishnan and Lobo (2010) that provisions for losses on credit operations represent banking institutions' main accruals, with a high degree of subjectivity, which justifies concerns from auditors, users and regulators themselves about accounting practices adopted by management in this estimation.

After the PECLD, PAA reports on tax credits, passive provisions and actuarial matters, which had already emerged among the topics most frequently used by auditors to modify opinions or to present emphasis, should be highlighted. Auditors' justifications for considering tax credits as PAA cite the relevance of these assets balances, the use of future profitability estimates and the impact that any changes in assumptions may cause in financial statements. For

passive provisions, arguments are related to valuation, which involves complex and relevant estimates. In the case of actuarial matters (benefits to employees), the justification is that it involves actuarial assumptions, where calculations performed include discount rates, inflation and mortality rates, which is reflected in complexity in its accounting treatment.

The greatest novelty in relation to other topics is the recurrence with which the technology environment is cited as PAA – present in 45.2% of the total reports. Since banks' activities, including recording of all their transactions reflected in financial statements, are dependent on technology systems proper functioning, it is natural that this type of emphasis be attributed by independent auditors to the topic.

Another topic that has been highlighted as PAA was the fair value of financial instruments. This is justified by the relevance of these instruments in banks' equity structure and by the implicit subjectivity in these instruments measurement process when they do not have trading in an active secondary market.

4.4 Relationship among topics of opinion change, emphasis or PAA

Following the categorization and mapping of the most cited in audit reports three topics – opinion modification, emphasis paragraphs or PAA – the next step was to evaluate the association among them by using graphic analysis. The assumption is that, although used with a distinct focus, there should be a relationship among the topics that most concern auditors (PAA), which auditors consider relevant to emphasize to users (emphasis) and that materially distort financial statements (modification of opinion).

The first relationship studied focuses on the association between the most recurrent topics of opinion modification and emphasis, according to Figure 1.

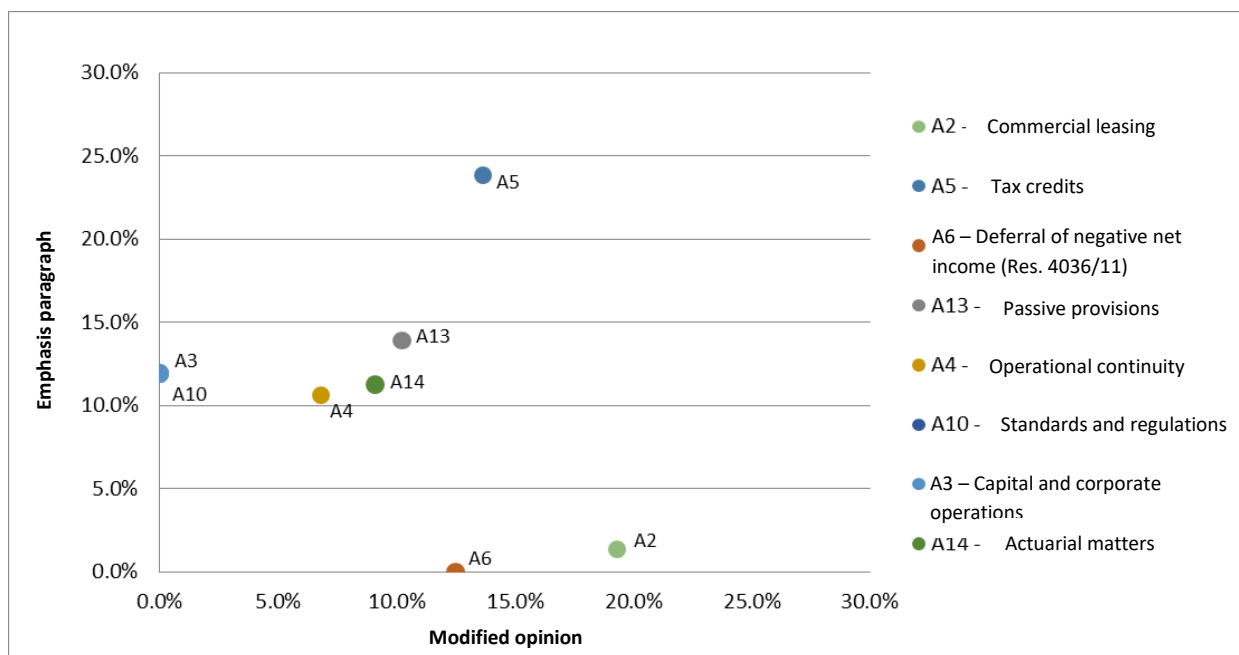


Figure 1. Relationship between the most cited topics for opinion modification and emphasis paragraphs in Brazilian banks' financial statements audit reports

Analysis of Figure 1 reveals, initially, that topics related to tax credits, passive provisions, actuarial matters (benefits to employees) and operational continuity, in this order of importance, are used as a justification for altering opinions and as an emphasis, revealing a positive association between the two scenarios.

In the case of topics relating to commercial leasing operations and deferral of negative net income, as allowed by CMN Resolution no. 4,036 of 2011, they are basically used to justify

modified opinions. On the other hand, topics related to regulatory capital and corporate operations and to standards and regulations are treated exclusively as elements highlighted in emphasis paragraphs. This asymmetry reveals that the first two topics are eminently accounting, not deserving to be highlighted as emphasis, although they constitute material misstatements in the statements, while the second block translates issues that are relevant to banking institutions' business, although they do not translate distortions into financial statements.

The second relationship analyzed evaluates the association between the topics used as an emphasis paragraph and the so-called PAA. This association is demonstrated in Figure 2.

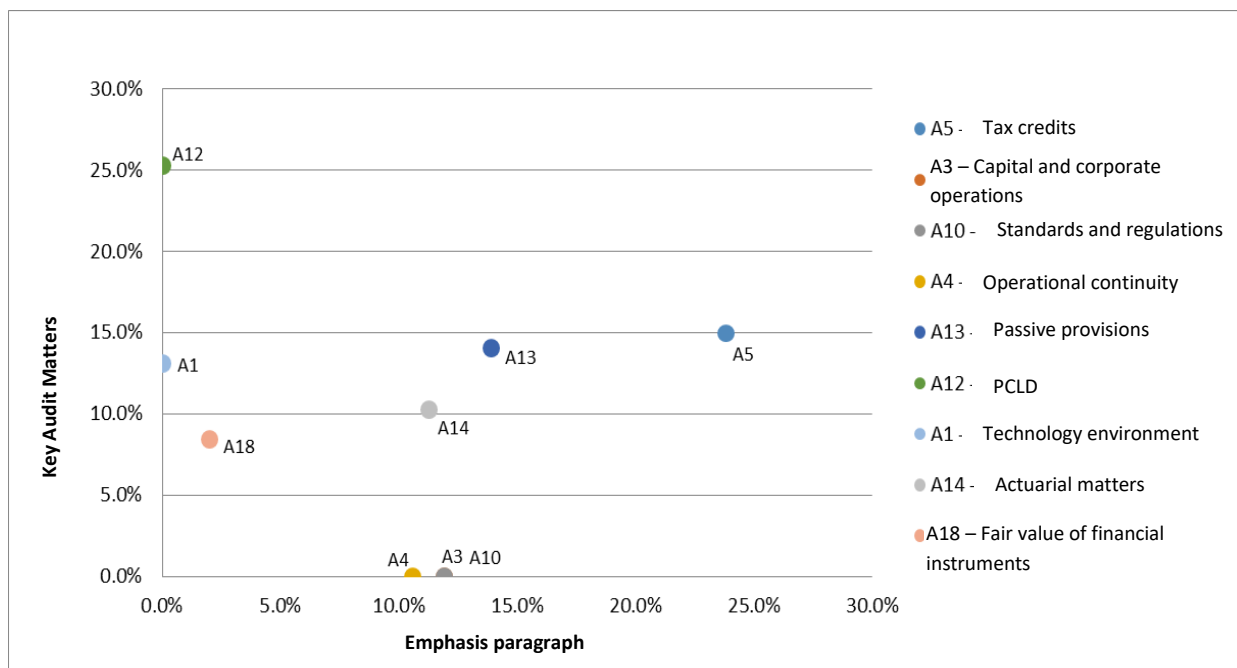


Figure 2. Relationship between the most cited topics for emphasis paragraphs and as PAA in Brazilian banks' financial statements audit reports

In a manner equivalent to that found in the association between the topics used as a change of opinion or emphasis, Figure 2 reveals that topics related to tax credits, liability provisions and actuarial matters are common in the emphasis paragraphs and in the PAA, although tax credits are proportionally more frequent in the emphases.

In asymmetric terms, topics surrounding PECLD, technology environment and fair value of financial instruments are highlighted as PAA and ignored in terms of emphasis paragraphs. On the other hand, among the most emphasized topics, emphasis should be given to those related to capital and corporate operations, standards and regulations and operational continuity, which were not mentioned among the PAA. Of these, it is worth noting that concern with operational continuity has not been cited as PAA, given the critical nature of the topic. This may be justified because PAA are required only for listed companies, which restricts their scope.

The third block of analysis focuses on the relationship among topics that led to changes in opinion and the PAA, highlighted in banks' financial statements audit reports, as evidenced in Figure 3.

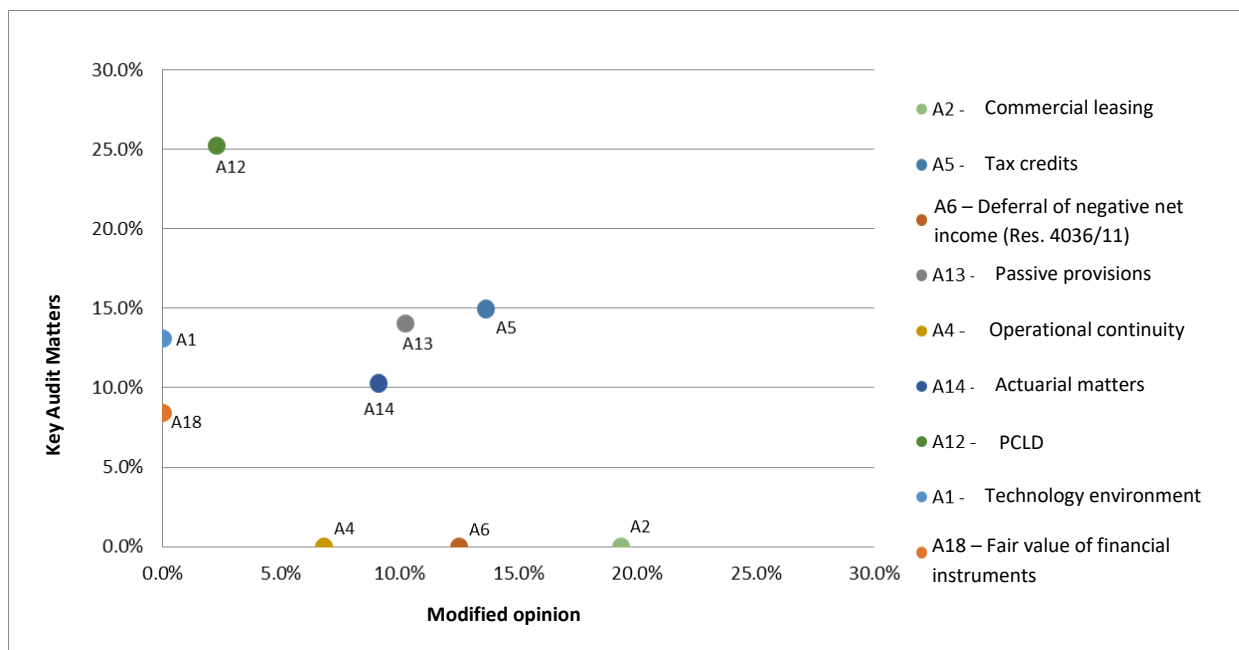


Figure 3. Relationship between the most cited topics for opinion modification and as PAA in Brazilian banks' financial statements audit reports

Again, topics relating to tax credit, passive provisions and actuarial matters (benefits to employees) are used for auditors to modify opinions and to stand out as a PAA, identifying a symmetrical relationship between the topics.

As a topic eminently used as PAA, PECLD – the most recurrent topic as PAA but which practically has not generated material misstatements in the statements –, the discussion about technology environment and the fair value of financial instruments are highlighted. At the other end, topics that were widely used to modify opinions and which did not appear as PAA were those related to commercial leasing operations, deferral of negative net income and operational continuity. Potential reasons for these asymmetries appear to be the same as those discussed in Figures 1 and 2.

5 CONCLUSIONS

The purpose of this study was to verify the relationship among topics mentioned in emphasis paragraphs, in bases for opinion with modification and in the PAA. For this purpose, reports issued by auditors on 134 Brazilian banks' statements from 2007 to 2016, totaling 746 reports, were examined by using the Content Analysis technique. Subsequently, the relationship among the six topics most cited as a basis for opinion modification, emphases and PAA was graphically evaluated.

Results revealed in the first analysis – Opinion with Modification versus Emphasis – that topics such as commercial leasing and deferral of net income were handled only in modified opinions. On the other hand, topics such as regulatory capital and corporate operations and standards and regulations were pointed out only in the emphasis paragraphs, revealing an asymmetry between eminently accounting issues and topics related to banking institutions' business. As a positive association, the existence of topics such as tax credits, passive provisions, actuarial matters and operational continuity was also concluded.

In the second analysis – Emphasis versus PAA – the positive relationship of the first analysis is preserved, except for operational continuity, which appears only in the emphases. In aspects of asymmetry, topics such as PECLD, technology environment and fair value of financial instruments, observed only in the PAA, have been verified. Cited only in the emphasis

paragraphs, topics related to capital and corporate operations, standards and regulations and operational continuity stand out.

The third analysis – Opinion with Modification versus PAA – evidences PECLD as the most recurrent topic as PAA but practically it has not generated material misstatement in the statements analyzed. Topics such as technology environment and fair value of financial instruments do not appear as a basis for change of opinion. On the other hand, the topics most used to modify opinion and which did not appear as PAA were those related to commercial leasing operations, deferral of negative net income and operational continuity.

The main limitation is the difficulty in collecting statements from all the banking institutions in the sample, especially from the smaller entities, which may cause some kind of bias in the analysis of results, considering that reports from the largest banks have been identified for the entire time frame of the study. As suggestions for future studies, it is recommended to monitor the use of the PAA, given the short duration of this innovation in auditors' communication processes. In addition, broadening the analysis of the relationship among the topics used to modify opinion, to emphasize and to highlight PAA in the scope of nonfinancial entities is suggested, since these should offer a level of heterogeneity that is broader than the financial segment.

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