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Do Audit Opinions Affect Earnings Persistence?

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Abstract: *In the professional literature, the largest number of studies focus on examining and analyzing the content of auditors' reports and their impact on the quality of financial statements, while a smaller number of authors examine the impact of audit opinions on earnings persistence. Since understanding the type of audit opinion undoubtedly allows investors to assess the quality of a company's earnings and predict future cash flows, this paper investigates whether they react differently when making capital investment decisions if the financial statements contain a modified opinion. By looking at the previous literature, the authors consider market reactions, especially when it comes to some kind of modified opinion, given that they can cause a negative reaction and affect the reduction of earnings persistence. The research results so far show, although inconsistent and unusual, still interesting results when it comes to the impact of the audit opinion on earnings persistence. By analyzing previous studies, the authors reveal whether investors give enough importance to the audit opinion when making financial and investment decisions, which could later affect the amount of additional capital, which is a necessary condition for development, especially in transition and developing countries. In addition to the conclusions of this paper being relevant for users of financial statements, especially investors, they are also significant for regulatory bodies, as they indicate the necessity of constant improvement of the accounting and auditing system.*

1. INTRODUCTION

The results of the business strategy and business decisions of the company's management are disclosed in a certain period in the form of various reports, and the most important and complex ones are financial statements. Companies' annual financial statements represent the basic source of information that different stakeholders, among which shareholders and investors stand out, use when making business decisions. They include plenty of useful information based on which it is possible to evaluate previous and future results, and, therefore, their reliability and objectivity must not be questioned. For these reasons, it is completely understandable that accountants focus on providing high-quality financial statements that represent the foundation of trust and mutual communication between companies and their stakeholders.

Audit plays a significant role in increasing the credibility of information in financial statements, as it provides independent assurance of their truthfulness and fair presentation. All communication regarding the performed external audit to the public takes place solely through the audit report. As the final product of the audit, this report is a very important document and the auditor's expressed opinion in it can certainly lead to a series of consequential reactions that affect not only the users of financial statements but also the company as an audit client. The impact of the auditor's opinion on future company operations can be reflected in different ways. More precisely, depending on the expressed opinion about the financial statements, there are different positive and negative reactions of the company's stakeholders, which ultimately affects the future company performance.

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According to Doan et al. (2021), the amount of accounting earnings is one of the most important criteria for evaluating the performance and perspective of a company's operations; an issue that is of particular interest is the influence of the auditor's opinion on earnings persistence. Persistent earnings are those that come from the company's recurring core activity and which can be reliably expected to be sustainable in the following accounting periods as well (Miletić, 2021). A higher level of persistence indicates greater sustainability of earnings and cash flows, which can be useful when assessing the value of capital (Atwood et al., 2010). On the other hand, the lower quality of the reporting result, and, therefore, the lower level of persistence, is characteristic of companies facing business and financial difficulties. A qualified audit opinion, which reflects problematic items in financial statements, has the potential to influence investors' expectations on the capital market, by signaling the impairment of earnings sustainability, and thus a decrease in the earnings response coefficient (Choi & Jeter, 1992).

Since theory and practice have several times shown that persistence is connected with investor's reaction to information about report results (Lipe, 1990), in this paper, by looking at the existing professional literature and recapitulating previous research results, an attempt will be made to analyze the direction of the auditor's opinion influence on investment decisions, and, consequently, on earnings persistence.

Following the subject matter, the paper is structured as follows. After the introductory considerations, in the first part, the importance of the audit, audit report and expressed opinion for the purpose of quality control of financial reporting is pointed out. The second part of the paper refers to persistence and predictability, as two important earnings attributes. The third part of the paper examines the relationship between the information in the audit reports and earnings persistence since the auditor's opinion can influence the stakeholders' decision-making, which also affects the company's future performance. The conclusions, implications and limitations of the study are presented in the fourth part of the paper.

2. AUDIT AS A MECHANISM OF QUALITY CONTROL OF FINANCIAL REPORTING

The idea that auditing is the "cornerstone" of all efforts to hold companies accountable and make financial reporting useful has been around for a long time (Baah & Fogarty, 2016). The increased turbulence of the world economy since the beginning of the 21st century has not reduced the collective reliance on auditing. On the contrary, in today's business conditions, the external audit of financial statements, more than ever, is an indispensable element of the financial reporting system, without which the desired level of trust in financial statements cannot be achieved, and which is crucial for reducing the information risk of investors and the efficient capital market. That is why the audit profession must constantly maintain the quality at the required level in order to ensure stability in social and economic relations by removing doubts that individuals and companies may have. Otherwise, with the threat to its reputation and with the reduction of the level of quality, the audit service itself can lose its true sense and become worthless.

In order for the external audit to fulfill its role and provide reasonable assurance of the truthfulness and objectivity of financial statements, it is based on a complex process of gathering and evaluating evidence. This process is summarized in the audit report, through which all communication between external auditors and stakeholders takes place, and which assures users that the disclosed information has been processed and prepared following accepted accounting standards. The audit report is of high quality if it is written in a way that clearly and unambiguously conveys the auditor's conclusions and responds to user needs, in terms of providing information, such as the type of audit opinion, as well as all other information that will be useful to users who read these statements.

Nevertheless, the auditor's opinion stands out as a key part of the report that gives credibility to the information in the financial statements in terms of their safe use for business decision-making (Andrić, 2004). Following the International Standards on Auditing (ISA), the auditor's opinion can be unmodified, that is, positive and modified. Auditors express a positive opinion when they are convinced that the financial statement truthfully and honestly shows the real state of affairs, profit, financial status, income, and expenses, per accounting standards. On the other hand, if the auditor concludes that the financial statement is not free from material misstatement or is unable to obtain sufficient appropriate audit evidence to conclude that the financial statement is free from material misstatement, then he gives a modified opinion. A modified opinion can be a qualified opinion, an adverse opinion and a disclaimer of opinion. What type of modification the auditor will apply is determined by the effect of the misstatement or limitations in the collection of evidence on the truthfulness and objectivity of the financial statements. If the auditor judges that misstatements have a material but not pervasive effect on the financial statements, he will express a qualified opinion. On the other hand, if the effect is material and pervasive, he will express an adverse opinion. If, on the other hand, the auditors are unable to gather sufficient adequate evidence, they will express a qualified opinion if those limitations have a material but not pervasive effect, that is, they will give a disclaimer of opinion if they have a material and pervasive effect on the financial statements (ISA 705). In order for the communication value of the audit report to be used to the maximum, a particularly important part of the report is the paragraph on key issues that provides additional information to the appropriate users and reduces the information asymmetry between the auditor and the information users (Vučković-Milutinović, 2019, p. 213).

Based on the audit opinion, capital owners should receive feedback on whether the financial statements truthfully and objectively depict the company's operations and, depending on this, be able to decide on capital investment. However, although the audit report, as the final product of the audit, is an important document, the question arises as to whether stakeholders really read and analyze this report in detail when making economic decisions. Carcello (2012) finds that as many as 91% of respondents, representatives of various investment organizations, do not read the unmodified audit report. One of the reasons may be that, although an external audit significantly ensures the credibility of financial statements by preserving investors' trust in them, the expectations of users of financial statements regarding the scope of external audit continuously exceed the benefits provided by the audit (Vučković Milutinović, 2018). The problem of the gap in expectations comes to the fore, especially in periods of crisis and periods in which corporate-financial scandals are immanent, and the reaction of the profession and regulatory bodies in such circumstances is necessary. Audit reporting is often singled out as one of the key areas of change to maintain and improve audit quality, which is particularly important because of the benefits it brings to the entire society, also enabling better dialogue and cooperation between auditors and stakeholders. This is because, when making business decisions, they rely on the information presented in the audited financial statements, and it can be said that the capital market practically depends on the quality of the audit service and the quality of the audit reports.

3. EARNINGS PERSISTENCE AND PREDICTIVE ABILITY OF FINANCIAL PERFORMANCE

After Graham and Dodd (1951) presented their theoretical views, and Ball and Brown (1968) confirmed them empirically, research related to the capital market became more and more frequently covered in the accounting literature. Although they are not new, earnings persistence and predictability are still considered relevant and interesting topics, both for practitioners and members of the academic community. In addition to persistence and predictability, volatility also belongs to the group of accounting qualitative attributes based on earnings trends in a series of consecutive accounting periods; however, due to the limited and predetermined scope of the paper, this attribute will not be subject to further analysis.

Persistence indicates the degree to which current earnings can maintain their value in subsequent accounting periods (Rajizadeh & Rajizadeh, 2014). With increasing persistence, the informative character of the reported result increases, which leads to a reduction of risk in business decision-making. According to Miletić (2021), earnings persistence is particularly important in the process of making investment decisions, as well as in capital valuation models, given that persistent results are sustainable, and as such highly valued by investors, so it should not be surprising that persistence is long also used as a synonym for quality.

Earnings predictability is closely related to persistence, and it derives from investment decision-making models, which are based on the assessment of the present value of the company. Since these models are based on the discounting of expected cash flows, the inputs of the model are of better quality if they are evaluated based on information that has a better predictive ability, and thus can influence the reduction of measurement errors (Miletić, 2021). Kothari (2001) states that the use of time series is important for understanding the role of earnings in making various assessments, considering their connection with the mentioned models. Previous literature indicates that persistence is measured using time series parameters in order to capture the proportion of earnings that are expected to be sustained in future accounting periods (Subramanyam & Wild, 1996). According to Stigler (1963), earnings persistence is the correlation of the rate of return at two different points in time, such as t and t-1. A high correlation indicates high persistence and vice versa.

The influence of certain aspects of quality on the perception of users of financial statements and their decisions are the subject of analysis by many authors. As Miletić (2021) states, in addition to the fact that persistence affects the reduction of information asymmetry and uncertainty, it also enables current earnings to better predict future earnings, and also for investors to notice business trends more simply. As investment decisions cannot be based only on the current amount of earnings, such as earnings in year t, investors use data on a series of earnings over a longer period, better known as "permanent earnings" (Pimentel & Lima, 2010). When it comes to the relationship between accounting results, investors' decisions and stock prices, the results of some studies show that companies that manage to maintain the previously achieved level of the reported result are "rewarded" by investors, and therefore have a higher P / E ratio (Barth et al., 1999). On the other hand, companies that are unable to meet investors' expectations in terms of accounting earnings result in lower share prices.

Proceeding from the theoretical positions that state that greater earnings sustainability should be associated with a more pronounced reaction of investors to reporting information and results, Graham and Dodd (1951) conclude that the information contained in financial statements serves the purpose of making different types of assessments. However, the research results in Georgia (Pirveli, 2020) indicate that investors, creditors and lenders often make their decisions based on the amount of collateral or information from internet sites, and less on information from financial statements. Pirveli (2020) concludes that investors are largely uninterested in the information provided by financial statements and that the focus is increasingly shifting to tax authorities. The question is then, who are the disclosed financial statements intended for? Does this mean that quantitative information is increasingly being used for tax purposes and less by the actual users of financial statements?

While Dechow et al. (2010) advocate that persistence has a foothold in the repetitive activities of the company, as well as that accounting results are on average more persistent than cash flows, Moghaddam et al. (2016) come to different results with their research. They prove that relying on the current earnings allows investors, creditors and lenders to predict the earnings in the next accounting period with a probability of only 20%. Further analysis shows that cash flows from operating activities can be predicted in the next year with a probability of about 35%. The authors conclude that the possibility of predicting in Georgia based on accounting results and cash flows in the private sector is at a relatively low level. The research results further show that external stakeholders are poorly oriented to the use of information from financial statements, as well as that there are limitations in the accounting and auditing profession, which can significantly reduce investor confidence when it comes to assessments based on financial performance.

For economic and investment decisions to be based on true and fair financial statements, it is necessary to reduce the information risk to an acceptable level, which can be achieved through the external audit process. In the rest of the paper, by looking at the previous literature, we analyze the relationship between the external audit of financial statements and earnings persistence. We try to find out whether and how information signaled by auditors through audit reports, such as the type of audit opinion, can affect earnings sustainability.

4. THE RELATIONSHIP BETWEEN AUDIT OPINION AND EARNINGS PERSISTENCE

To analyze the relationship between information in audit reports and investors' reactions to the market, the authors proceed from the signaling theory, proposed by Spence (1973), which explains the behavior of two parties that have access to different information. In the financial market, more informed participants are better able to make business decisions that allow them to gain greater benefits compared to other participants. Contracts that are concluded in case of not having equal, or having equal but incorrect information, can lead to the wrong allocation of capital (Bini et al., 2011). Based on the signaling theory, according to which contracts are constantly made and renewed on the market, investors expect accurate information about the company's performance (Holden & Subrahmanyan, 1992).

The external audit comes to the fore as the most important mechanism for communicating the extent to which financial statements fairly depict the financial status, profit and loss and cash flows of companies, especially in economies where unreliable financial reporting is often a problem (Vučković-Milutinović, 2019). Given that company management and audit firms should send reliable signals to the market (Healy & Palepu, 2001), signaling theory has been widely used in both accounting and auditing research. Since the investor evaluates the disclosed and audited information either as a good or a bad sign, it is clear why quality audit reports are considered an important signal that can play an enviable role in the allocation of capital on the market, while the audit process itself can represent one of the mechanisms for overcoming personal interests of managers (Hewage & Ediriwickrama, 2022).

When talking about accounting earnings, any modification related to them has the potential to influence the decisions of participants on the capital market, by indicating their reduced persistence, which is consequently reflected in the reduction of the earnings response coefficient. As studies concerning the relevant issues are of long-term interest to researchers in the field of financial accounting, the review of the literature finds interesting, but conflicting results.

Research results by numerous authors who believe that the auditor's opinion leads to a great extent to the consequent reactions of stakeholders that affect the company itself are given in the rest of the paper. Choi and Jeter (1992) indicate that an unmodified auditor's opinion can provide a positive signal to investors and result in positive market returns and that a qualified opinion (as a type of modification) is closely related to lower earnings response coefficients. Similarly, Vichitsarawong and Pornupatham (2015) indicate that audit qualifications signal to the market that the firm will undergo appropriate financial changes, which are likely to result in less persistent performance. Vučković-Milutinović (2019) indicates that the auditor's modified opinion is a sign that the reliability of the financial statements, as well as the investor's trust in the financial statements, has been impaired, which can lead to unfavorable consequences for the audited entity. According to Menon and Williams (2010), modified audit reports that express doubts about the continuation of business lead to a negative market reaction, which can be reflected in the decline in the company's share prices on the financial market. If investors show interest in the content of the modified audit report, it is expected that they will refrain from investing capital in the respective companies, where the weakened financial situation, reduced profitability and lower stability of earnings are already noticeable (Hewage & Ediriwickrama, 2022). The said auditor's opinion can potentially further increase the uncertainty in current and future earnings and lead to even lower earnings quality and persistence (Moghaddam et al., 2016). Frost (1997) finds that companies that receive a modified opinion in the audit report are weaker and show a significant decrease in profitability compared to companies that receive an unmodified opinion. Therefore, according to this author, the audit modifications reflect some problematic accounting items that have the potential to increase the degree of uncertainty in the current and future company earnings, which further results in a lower quality of the reporting result. Sundgren (2009) finds that different types of modification in audit reports create a higher possibility of bankruptcy. Accordingly, Lam and Mensah (2006) find that firms that receive an unmodified opinion are likely to survive afterward, while those that receive a qualified one experience more serious financial problems. The conditions for issuing such an opinion imply a lower degree of earnings sustainability.

Thus, the views of this group of authors support the understanding that by modifying the opinion, the auditor controls the work of managers and limits their opportunistic behavior (Barizah Abu Bakar et al., 2005) regarding the choice between accounting policies and estimates made possible by the flexibility of ISA/IFRS, as well as regarding the intentional omission of material facts. It certainly attracts the special attention of the company's stakeholders and affects their future business decisions, which are reflected in the company's future performance.

Contrary to these views, there are research results that state that the information contained in audit reports has little informational value for investors (Hewage & Ediriwickrama, 2022).

Moghaddam et al. (2016) analyzed companies on the Tehran Stock Exchange from 2009 to 2013, to conclude that there is no significant relationship between modified audit reports and earnings persistence. Such attitudes point to the conclusion that the company's stakeholders do not rely on audit reports when making business decisions, and consequently their decisions, and then the future performance of the company, are not conditioned by the expressed audit opinion (Anulasiri et al., 2015).

5. CONCLUSION

Since, according to the arguments in the previous professional literature, the auditor's opinion has significant abilities when it comes to expressing transparent business information, but also indicating the existence of financial difficulties for the company. The subject of the study is a qualitative analysis of the connection between the auditor's opinion and earnings persistence. Based on the review of the existing literature, the influence of information from audit reports, primarily the audit opinion, on investment decisions and the sustainability of the report result is examined. We find that for companies that receive some kind of modified audit opinion, earnings persistence is not immanent, which means that in such companies it cannot be reliably expected that the results will be sustainable in the following accounting periods, in contrast to companies where the auditors conclude that the financial statements truthfully and honestly present the real state of affairs, profit, financial status, income, expenses and that they are following accounting standards. In such companies, the unmodified opinion gives a positive signal to investors, which consequently leads to higher market returns. Based on the results of the analyzed studies, we conclude that there is a certain percentage of investors who do not rely on information from financial statements and audit reports, who are not aware of the importance of their informative value and who do not consider the content of those reports to a large extent when making business decisions.

This paper includes certain economic implications. First, emphasizing the importance of the quality of the audit report model is vital to providing users with adequate insight into the issues that are most significant in carrying out the audit. Raising the informative value of the audit report for users, especially for investors, and enabling a better understanding of the audited financial statements, is important because of their use in making economic decisions. With the support of information provided in a quality audit report, the future company performance and earnings quality can be predicted and financial and investment decisions can be made, which can be the basis for shaping future directions and the dynamics of modern economic flows. The inflow of domestic and foreign capital is important for company growth and development, earnings level and persistence, but also for the entire national economy, especially if it is a question of developing countries. It should be noted here that, unlike developed countries, where modified audit opinions appear less often in practice, in developing countries the mentioned opinion is not only more frequent, but also not treated seriously enough, both by regulatory bodies and by investors. Findings of this type are worrying, because modifications in the audit report may indicate a "red flag" that warns of various types of uncertainty in the operations of a specific company. That is why it is recommended that investors, as well as other users of the report, take an analytical approach to read the audit report before making a decision, and not recklessly make investments and thus make wrong moves that can sometimes have a negative impact on the entire national economy. Also, if we take into account the public nature of financial statements and audit reports, it is clear how much responsibility the regulatory bodies have, which should use their authoritative position to emphasize and highlight the importance of using audit reports.

Finally, we outline some of the limitations of this paper and potential ideas for future research. In this paper, no specific empirical research is conducted to examine the relationship between different types of audit opinions and earnings persistence. Also, the research subject refers solely to companies from the private sector. Studies that include an analysis of the impact of audit opinion on earnings persistence in the public sector are lagging. Bearing in mind the above, one of the interesting extensions of this study would be empirical research that would include private and/or public sector companies, first of all, on the territory of the Republic of Serbia, when the direction of influence of the auditor's opinion on the sustainability of the reporting result in these companies would be examined. The study could further be extended to the countries of the former Socialist Federal Republic of Yugoslavia (SFRY), considering that these countries once belonged to one state. Among the respective countries, some are members of the European Union (the Republic of Croatia and the Republic of Slovenia) and those that are not yet (the Republic of Serbia, the Republic of Montenegro, Bosnia and Herzegovina and North Macedonia), which could possibly lead to interesting differences in the results.

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