

TRENDS ON REPORTING MATERIALITY INFORMATION IN THE INDEPENDENT AUDITOR'S REPORT – CASE OF CROATIA

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ABSTRACT

It is known that the financial statement audit represents the corporate governance mechanism crucial for ensuring the appropriate quality of the financial reporting process and financial statements. One of the most significant aspects of the financial statement audit process is the application of the materiality concept. Auditors apply the concept in planning and performing the process, as well as in evaluating the effects of identified misstatements. The International Accounting Standards Board (IASB) defines that the information provided in financial statements is material if could reasonably be expected that will influence the business decisions of the stakeholders. Although not mandatory, recent Standards and regulation changes resulted in reporting materiality details by a significant number of auditors in Croatia. The research question is how that practice develops from the implementation year, 2016, to nowadays, 2020, and what can be expected in the future. Following the research problem, the objective of the paper will be to investigate the current state and future perspective of disclosing information regarding materiality in the independent auditor's report in Croatia. To investigate the research problem, we analyzed independent auditor's reports of Croatian listed companies (public interest entities - PIEs) from 2016 to 2019. The research is conducted by applying appropriate statistical methodology as descriptive statistics, cluster analysis, and non-parametric tests, and regression analysis.

KEYWORDS: *financial statement audit, the International Standards on Auditing, independent auditor's report, materiality, key audit matters, public-interest entities, the IAASB, communication gap, information gap*

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1. INTRODUCTION

Managing business operations in a contemporary, dynamic, chaotic, and unstable environment is extremely challenging. That is especially emphasized for the largest companies, as public-interest entities (PIEs) characterized by different stakeholders, higher visibility and public interest, and great economic impact. European legislation defines public-interest entities as the ones whose transferable securities are admitted to trading on a regulated market of any European Union state, including credit institutions, insurance undertakings.¹ Croatian Accounting Act, which is harmonized with European legislations, next to quoted companies, credit institutions and insurance undertakings, as public-interest entities classifies a wide range of other financial institutions (for example, investment funds, leasing-companies, re-insurance companies, factoring companies, pension funds), legal entities of special interest for the Republic of Croatia, entities that employ more than 5000 employees, or the one that has a total asset greater than 5 billion HRK, and others.² The latter is subject to a joint audit under the Audit Act.³ Business operations and management processes in those entities are complex, more regulated, and assume branched organizational structure, with a multilevel chain of command with a different range of responsibilities. Additionally, shareholders are most probably not included in the managing process. Nevertheless, they expect adequate results aligned with the mission, vision, and strategic objectives of the entity. They are usually represented by the supervisory board, which is the body that serves as guardians and promoters of shareholders' interests. From the theoretical point of view, the management interests on the one side, and shareholders on the other, is known as an agency theory. Undoubtedly, the interest of agents (management) and principles (stockholders) should be harmonized and directed to the long-term prosperity, growth, and development of the company. Nevertheless, in certain circumstances, their interest may differ. The crucial role in aligning their expectations and interests has different corporate governance mechanisms. Corporate governance covers multidimensional aspects of managing the business operations of the company to reconcile differences caused

¹ Directive 2014/56/EU of the European Parliament and of the Council of 16 April 2014 amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts, 13. [<https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32014L0056>], accessed on 04/11/2020.

² Accounting Act, (Official Gazette number 78/2015, 134/2015, 120/2016, 116/2018, 42/2020, 47/2020), Article 3, [https://narodne-novine.nn.hr/clanci/sluzbeni/2007_10_109_3174.html], accessed on 04/11/2020.

³ Audit Act, (Official Gazette number 127/2017), Article 43, [https://narodne-novine.nn.hr/clanci/sluzbeni/2017_12_127_2873.html], accessed on 04/11/2020.

by theory agency. Following the OECD, the role of corporate governance is to ensure an environment of trust, followed by a transparent and accountable management process aimed to foster financial stability and business integrity.⁴ The Foundation of corporate governance are principles divided into six chapters. As a result of extensive empirical and analytical research related to the emerging trends, especially in the financial and corporate sector, then in technology and cybersecurity, in 2015, the OECD issued updated principles.

To measure business performance and strategic objectives achievement, or to assess if the company meets expected returns for the shareholders, financial data available from the accounting information system is used. For the external stakeholders, necessary financial data is available from annual or quarterly financial statements. The output information is valuable as a quality of the input data. Managers are responsible to ensure the application of adequate measurement, presentation, derecognition, and disclosure of accounting concepts. In the case of European and Croatian public-interest entities, the financial reporting framework is prescribed by International Financial Reporting Standards. The objective of financial reporting is to provide useful information to existing and potential stakeholders. "If financial information is to be useful, it must be relevant and faithfully represent what it purports to represent. The usefulness of financial information is enhanced if it is comparable, verifiable, timely and understandable."⁵ Qualitative characteristics of useful information are relevance and faithful representation. An important aspect of understanding the usefulness of information has a materiality concept. As it can be concluded, financial information presented in financial statements have an irreplaceable role for all stakeholders, and in that context, it is crucial that the information is fairly and objectively presented. The fifth corporate governance principle promotes disclosure and transparency. The corporate governance framework should "ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company".⁶ According to the principles, corporate governance mechanisms have a crucial role in ensuring

⁴ OECD: G20/OECD Principles of Corporate Governance, 2015, [https://www.oecd-ilibrary.org/governance/g20-oecd-principles-of-corporate-governance-2015_9789264236882-en;jsessionid=nK8BfisYg9Rg0tEv2ekV330z.ip-10-240-5-39], accessed on 04/11/2020.

⁵ IASB: IFRS Conceptual Framework for Financial Reporting, 2018, p. 14, [<https://incp.org.co/Site/publicaciones/info/archivos/Conceptual-Framework-2018-03042018.pdf>], accessed on 04/11/2020.

⁶ OECD: G20/OECD Principles of Corporate Governance, 2015, p. 37, [https://www.oecd-ilibrary.org/governance/g20-oecd-principles-of-corporate-governance-2015_9789264236882-en;jsessionid=nK8BfisYg9Rg0tEv2ekV330z.ip-10-240-5-39], accessed on 04/11/2020.

high-quality financial information. The most important corporate governance mechanisms in the execution of those responsibilities are audit committee, internal auditors, and independent statutory auditors. By the second principle, it is emphasized that shareholder should have the opportunity to ask questions to the board relating to the annual external audit.⁷

The audit committee is a specialized sub-board of the supervisory board formed to “help to minimize financial, operational and compliance risks, and enhance the quality of financial reporting.”⁸ On the other hand, the most important role in assuring that financial statements present fair and objective information have independent statutory auditors. External auditors have an irreplaceable role in providing objective assurance to the board and shareholders that the financial statements fairly represent the financial position and performance of the company in all material respects.⁹ The role of the audit committee is to monitor the financial reporting process and review and monitor the auditors’ independence and in particular the provision of additional, especially non-audit services to the company.¹⁰ On the other side, external auditors have to ensure independence and use appropriate levels of professional competence and skepticism in their activities. “External auditors should be accountable to the shareholders and owe a duty to the company to exercise due professional care in the conduct of the audit.”¹¹ External auditors should adhere to the highest ethical standards by employing integrity, objectivity, professional competence, and due care. European and, accordingly Croatian, legislation prescribes

⁷ OECD: G20/OECD Principles of Corporate Governance, 2015, p. 21, [https://www.oecd-ilibrary.org/governance/g20-oecd-principles-of-corporate-governance-2015_9789264236882-en;jsessionid=nK8BfisYg9Rg0tEv2ekV330z.ip-10-240-5-39], accessed on 04/11/2020.

⁸ Directive 2014/56/EU of the European Parliament and of the Council of 16 April 2014 amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts, 24. [https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32014L0056], accessed on 04/11/2020

⁹ OECD: G20/OECD Principles of Corporate Governance, 2015, p. 43, [https://www.oecd-ilibrary.org/governance/g20-oecd-principles-of-corporate-governance-2015_9789264236882-en;jsessionid=nK8BfisYg9Rg0tEv2ekV330z.ip-10-240-5-39], accessed on 04/11/2020.

¹⁰ Directive 2014/56/EU of the European Parliament and of the Council of 16 April 2014 amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts, 39 [https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32014L0056], accessed on 04/11/2020

¹¹ OECD: G20/OECD Principles of Corporate Governance, 2015, p. 44, [https://www.oecd-ilibrary.org/governance/g20-oecd-principles-of-corporate-governance-2015_9789264236882-en;jsessionid=nK8BfisYg9Rg0tEv2ekV330z.ip-10-240-5-39], accessed on 04/11/2020.

that public-interest entities shall have an audit committee and that at least one member of the committee shall be independent and shall have competence in accounting and/or auditing.¹² The audit committee has the most extensive communication with companies' internal auditors and statutory auditors. Both of them have responsibilities to report their activities, findings, and results to the audit committee. Related to the financial reporting process, statutory auditors "shall report to the audit committee on key matters arising from the statutory audit, and in particular on material weaknesses in internal control in relation to the financial reporting process".¹³

2. THEORETICAL BACKGROUND AND HYPOTHESIS DEVELOPMENT

Considering the importance of the public-interest entities for an economy of the country and a large number of interested parties, financial statement audits in European Union for those entities are specially regulated with a wide range of requests and legislation constraints. In that context, financial statement audits are known as statutory audits, and they are conducted by statutory auditors. "Statutory auditors and audit firms are entrusted by law to conduct statutory audits of public-interest entities with a view to enhancing the degree of confidence of the public in the annual and consolidated financial statements of such entities."¹⁴ In general, statutory audit is "an audit of annual accounts or consolidated accounts insofar as required by Community law".¹⁵ The purpose of an audit of financial statements is to "enhance the degree of confidence of intended users in the financial statements" by expressing an opinion by

¹² Directive 2014/56/EU of the European Parliament and of the Council of 16 April 2014 amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts, Article 39, [[https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex-%3A32014L0056](https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32014L0056)], accessed on 04/11/2020

¹³ Directive 2014/56/EU of the European Parliament and of the Council of 16 April 2014 amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts, Article 39, [[https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex-%3A32014L0056](https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32014L0056)], accessed on 04/11/2020

¹⁴ Regulation (EU) No 537/2014 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 16 April 2014 on specific requirements regarding statutory audit of public-interest entities and repealing Commission Decision 2005/909/EC, 1, [<https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32014R0537>], accessed on 04/11/2020.

¹⁵ Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC, Article 2, [<https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32006L0043>], accessed on 04/11/2020.

the independent auditor (professional accountant) on “whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework”, i.e. “whether the financial statements are presented fairly, in all material respects, or give a true and fair view in accordance with the framework”.¹⁶ The financial reporting framework prescribed for European and Croatian public-interest entities is the International Financial Reporting Standards. Statutory audits in European Union must be carried out in compliance with international auditing standards adopted by the Commission, where international auditing standards mean International Standards on Auditing (ISA) and related *Statements* and *Standards*, insofar as relevant to the statutory audit.¹⁷ The results of statutory audits are presented in an audit report, i.e. independent auditor’s report. As it was stated earlier, Croatian legislation is harmonized with European, and in that context, the Croatian Audit Act prescribes that an audit report is a report of the independent auditor prepared in compliance with International Standards on Auditing (ISA).¹⁸ The most relevant part of the independent auditor’s report is an auditor’s opinion about the fair and objective presentation of financial position, business performance, and cash flows in financial statements in all material respects under the International Financial Reporting Standards. The opinion formed by the auditor is useful and relevant if an audit is conducted following ISAs and relevant ethical requirements.¹⁹

Foundation of audit activity is obtaining “reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error”.²⁰ The ISA defines misstatements as “a between

¹⁶ IAASB: Handbook of International Quality Control, Auditing Review, Other Assurance, and Related Services Pronouncements, 2012 Edition, Volume I, ISA 200, 3, p. 73, [https://www.ifac.org/system/files/publications/files/2012%20IAASB%20Handbook%20Part%20I_Web.pdf], accessed on 04/11/2020.

¹⁷ Directive 2014/56/EU of the European Parliament and of the Council of 16 April 2014 amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts, Article 2 and Article 26, [https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32014L0056], accessed on 04/11/2020

¹⁸ Audit Act, (Official Gazette number 127/2017), Article 4, [https://narodne-novine.nn.hr/clanci/sluzbeni/2017_12_127_2873.html], accessed on 04/11/2020.

¹⁹ IAASB: Handbook of International Quality Control, Auditing Review, Other Assurance, and Related Services Pronouncements, 2012 Edition, Volume I, ISA 200, 4, p. 73, [https://www.ifac.org/system/files/publications/files/2012%20IAASB%20Handbook%20Part%20I_Web.pdf], accessed on 04/11/2020.

²⁰ IAASB: Handbook of International Quality Control, Auditing Review, Other Assurance, and Related Services Pronouncements, 2012 Edition, Volume I, ISA 200, 5, p. 74, [https://www.ifac.org/system/files/publications/files/2012%20IAASB%20Handbook%20Part%20I_Web.pdf], accessed on 04/11/2020.

the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.”²¹ In the context of the auditor’s opinion, misstatements also include adjustments necessary for the financial statements to be presented fairly, in all material respects. Nevertheless, auditors do not obtain absolute, but they obtain reasonable assurance (high level of assurance), “because there are inherent limitations of an audit which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor’s opinion being persuasive rather than conclusive”.²² “The auditor obtains reasonable assurance by obtaining sufficient appropriate audit evidence to reduce audit risk to an acceptably low level.”²³ “The phrase obtain reasonable assurance is intended to inform users that auditors do not guarantee or ensure the fair presentation of the financial statements. Some risk that the financial statements are not fairly stated exists, even when the opinion is unmodified.”²⁴ Quantitatively speaking, the level of risk is determined by the percentage of acceptable audit risk. Considering that auditors obtain reasonable assurance, they have to apply the concept of materiality in their activities. “In general, misstatements, including omissions, are considered to be material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.”²⁵ “The phrase free of material misstatement is intended to inform users that the auditor’s responsibility is limited to material financial information. Materiality is important because it is impractical

²¹ IAASB: Handbook of International Quality Control, Auditing Review, Other Assurance, and Related Services Pronouncements, 2012 Edition, Volume I, p. 26, [https://www.ifac.org/system/files/publications/files/2012%20IAASB%20Handbook%20Part%20I_Web.pdf], accessed on 04/11/2020.

²² IAASB: Handbook of International Quality Control, Auditing Review, Other Assurance, and Related Services Pronouncements, 2012 Edition, Volume I, p. 26, [https://www.ifac.org/system/files/publications/files/2012%20IAASB%20Handbook%20Part%20I_Web.pdf], accessed on 04/11/2020.

²³ IAASB: Handbook of International Quality Control, Auditing Review, Other Assurance, and Related Services Pronouncements, 2012 Edition, Volume I, ISA 320, A1, p. 317, [https://www.ifac.org/system/files/publications/files/2012%20IAASB%20Handbook%20Part%20I_Web.pdf], accessed on 04/11/2020.

²⁴ Arens, A., A.; Edler, R. J.; Beasley, M. S.; Hogan, C. E.: *Auditing and Assurance Services: An Integrated Approach*, 16th Edition, Pearson Education, Inc., USA, 2017, p. 262.

²⁵ IAASB: Handbook of International Quality Control, Auditing Review, Other Assurance, and Related Services Pronouncements, 2012 Edition, Volume I, ISA 200, 6, p. 74, [https://www.ifac.org/system/files/publications/files/2012%20IAASB%20Handbook%20Part%20I_Web.pdf], accessed on 04/11/2020.

for auditors to provide assurances on immaterial amounts.”²⁶ The concept of materiality arises from the financial reporting framework. The International Financial Reporting Standards define materiality as “an entity-specific aspect of relevance based on the nature or magnitude, or both, of the items to which the information relates in the context of an individual entity’s financial report. Consequently, the Board cannot specify a uniform quantitative threshold for materiality or predetermine what could be material in a particular situation.”²⁷ Further to this, the ISAs state that auditor is making judgments about materiality, in the light of surrounding circumstances, and are affected by the auditor’s perception of the financial information needs of users of the financial statements, and by the size or nature of a misstatement, or a combination of both. (...) “The auditor is not responsible for the detection of misstatements that are not material to the financial statements as a whole.”²⁸ In that context, auditors determine tolerable misstatement which is “a monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population.”²⁹ The risk that the amount of tolerable misstatement is exceeded before the audit is a risk of material misstatement, which consists of two components, inherent risk and control risk. To minimize the risk of material misstatements and to obtain reasonable assurance that financial statements are free from material misstatements, auditors in their activities must exercise professional judgment and maintain professional skepticism. Professional judgment assumes “application of relevant training, knowledge and experience, within the context provided by auditing, accounting and ethical standards, in making informed decisions about the courses of action that are appropriate in the circumstances of the audit engagement”.³⁰

²⁶ Arens, A., A.; Edler, R. J.; Beasley, M. S.; Hogan, C. E.: *Auditing and Assurance Services: An Integrated Approach*, 16th Edition, Pearson Education, Inc., USA, 2017, p. 262.

²⁷ IASB: IFRS Conceptual Framework for Financial Reporting, 2018, p. 15, [<https://incp.org.co/Site/publicaciones/info/archivos/Conceptual-Framework-2018-03042018.pdf>], accessed on 04/11/2020.

²⁸ IAASB: Handbook of International Quality Control, Auditing Review, Other Assurance, and Related Services Pronouncements, 2012 Edition, Volume I, ISA 200, 6, p. 74, [https://www.ifac.org/system/files/publications/files/2012%20IAASB%20Handbook%20Part%20I_Web.pdf], accessed on 04/11/2020.

²⁹ IAASB: Handbook of International Quality Control, Auditing Review, Other Assurance, and Related Services Pronouncements, 2012 Edition, Volume I, p. 36, [https://www.ifac.org/system/files/publications/files/2012%20IAASB%20Handbook%20Part%20I_Web.pdf], accessed on 04/11/2020.

³⁰ IAASB: Handbook of International Quality Control, Auditing Review, Other Assurance, and Related Services Pronouncements, 2012 Edition, Volume I, p. 29, [<https://www.ifac.org/>]

Professional judgment is obtained by experience. On the other hand, professional skepticism is “an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of evidence”.³¹ “Professional skepticism an attitude that includes a questioning mind, being alert to conditions that may indicate possible misstatement due to fraud or error, and a critical assessment of audit evidence.”³²

Materiality is a key auditing concept that is first assessed during the risk assessment phase of every audit.³³ ISA 320 *Materiality in planning and performing an audit* deals with the auditor’s responsibility to apply the concept of materiality in planning and performing an audit of financial statements, and ISA 450 *Evaluation of Misstatements identified during the Audit* explains how materiality is applied in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements. Although, it may seem that determining materiality is a fairly simple activity, it is by no means such. “The auditor’s determination of materiality is a matter of professional judgment, and is affected by the auditor’s perception of the financial information needs of users of the financial statements.”³⁴ In that context it is expected from the users of financial statements that they possess reasonable knowledge of business and economic activities and accounting; understand that financial statements are prepared, presented and audited to levels of materiality; recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment and the consideration of future events; and Make reasonable economic decisions on the basis of the information in the financial statements.³⁵

system/files/publications/files/2012%20IAASB%20Handbook%20Part%20I_Web.pdf], accessed on 04/11/2020.

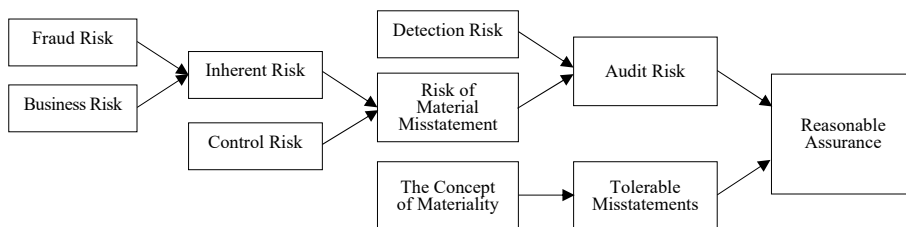
³¹ IAASB: Handbook of International Quality Control, Auditing Review, Other Assurance, and Related Services Pronouncements, 2012 Edition, Volume I, p. 30, [https://www.ifac.org/system/files/publications/files/2012%20IAASB%20Handbook%20Part%20I_Web.pdf], accessed on 04/11/2020.

³² Johnson, R. N.; Wiley, L. D.: *Auditing: A Practical Approach with Data Analytics*, John Wiley & Sons, Inc., Hoboken, NJ, USA, 2019, p. 3-15.

³³ Johnson, R. N.; Wiley, L. D.: *Auditing: A Practical Approach with Data Analytics*, John Wiley & Sons, Inc., Hoboken, NJ, USA, 2019, p. 3-11.

³⁴ IAASB: Handbook of International Quality Control, Auditing Review, Other Assurance, and Related Services Pronouncements, 2012 Edition, Volume I, ISA 320, 4, p. 314-315, [https://www.ifac.org/system/files/publications/files/2012%20IAASB%20Handbook%20Part%20I_Web.pdf], accessed on 04/11/2020.

³⁵ IAASB: Handbook of International Quality Control, Auditing Review, Other Assurance, and Related Services Pronouncements, 2012 Edition, Volume I, ISA 320, 4, p. 315, [https://www.ifac.org/system/files/publications/files/2012%20IAASB%20Handbook%20Part%20I_Web.pdf], accessed on 04/11/2020.



Auditors apply materiality concept both in planning and performing the audit as well in evaluating the effects of identified misstatements on the audit and of uncorrected misstatements. The first phase concerning materiality is in planning the engagement where auditor makes judgments about the size of misstatements that will be considered material. These judgments provide a basis for: determining the nature, timing and extent of risk assessment procedures; identifying and assessing the risks of material misstatement; and determining the nature, timing and extent of further audit procedures.³⁶ The materiality determined when planning the engagement “does not necessarily establish an amount below which uncorrected misstatements”.³⁷ New insights and findings during the performing of engagement may result in re-evaluating the acceptable levels of materiality and risk of tolerable misstatement, which leads to re-assessing the needed amount of audit evidence for forming an opinion. “The auditor shall revise materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) in the event of becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially.”³⁸

To reduce audit risk, auditors should determine the level of performance materiality, which represents “the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately

www.ifac.org/system/files/publications/files/2012%20IAASB%20Handbook%20Part%20I_Web.pdf, accessed on 04/11/2020.

³⁶ IAASB: Handbook of International Quality Control, Auditing Review, Other Assurance, and Related Services Pronouncements, 2012 Edition, Volume I, ISA 320, 6, p. 315, [https://www.ifac.org/system/files/publications/files/2012%20IAASB%20Handbook%20Part%20I_Web.pdf], accessed on 04/11/2020.

³⁷ IAASB: Handbook of International Quality Control, Auditing Review, Other Assurance, and Related Services Pronouncements, 2012 Edition, Volume I, ISA 320, 6, p. 315, [https://www.ifac.org/system/files/publications/files/2012%20IAASB%20Handbook%20Part%20I_Web.pdf], accessed on 04/11/2020.

³⁸ IAASB: Handbook of International Quality Control, Auditing Review, Other Assurance, and Related Services Pronouncements, 2012 Edition, Volume I, ISA 320, 12, p. 316, [https://www.ifac.org/system/files/publications/files/2012%20IAASB%20Handbook%20Part%20I_Web.pdf], accessed on 04/11/2020.

low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole”.³⁹ Auditors determine performance materiality “for purposes of assessing the risks of material misstatement and determining the nature, timing and extent of further audit procedures.”⁴⁰ “Performance materiality is an amount set by the auditor that is less than planning materiality and is used to make decisions about the extent of audit procedures for a particular class of transaction, account balance, or disclosure.”⁴¹ According to Arens (2016) performance materiality helps auditors to decide the appropriate audit evidence to accumulate, where the performance materiality is inversely related to the sample size, i.e. the amount of evidence that should be gathered.⁴² “The determination of performance materiality is based on professional judgment and reflects the amount of misstatement an auditor is willing to accept in a particular segment.”⁴³ Performance materiality actually represents tolerable misstatements.⁴⁴ “Auditors accept some level of risk or uncertainty in performing the audit function. The auditor recognizes, for example, the inherent uncertainty about the appropriateness of evidence, uncertainty about the effectiveness of a client’s internal controls, and uncertainty about whether the financial statements are fairly stated when the audit is completed. An effective auditor recognizes that risks exist and deals with those risks in an appropriate manner. Most risks auditors encounter are difficult to measure and require careful consideration before the auditor can respond appropriately. Because the assessment of risks is a matter of professional judgment, rather than a precise measurement, responding to these risks properly is critical to achieving a high-quality audit.”⁴⁵

³⁹ IAASB: Handbook of International Quality Control, Auditing Review, Other Assurance, and Related Services Pronouncements, 2012 Edition, Volume I, ISA 320, 9, p. 316, [https://www.ifac.org/system/files/publications/files/2012%20IAASB%20Handbook%20Part%20I_Web.pdf], accessed on 04/11/2020.

⁴⁰ IAASB: Handbook of International Quality Control, Auditing Review, Other Assurance, and Related Services Pronouncements, 2012 Edition, Volume I, ISA 320, 11, p. 316, [https://www.ifac.org/system/files/publications/files/2012%20IAASB%20Handbook%20Part%20I_Web.pdf], accessed on 04/11/2020.

⁴¹ Johnson, R. N.; Wiley, L. D.: *Auditing: A Practical Approach with Data Analytics*, John Wiley & Sons, Inc., Hoboken, NJ, USA, 2019, p. 3-13.

⁴² Arens, A., A.; Edler, R. J.; Beasley, M. S.; Hogan, C. E.: *Auditing and Assurance Services: An Integrated Approach*, 16th Edition, Pearson Education, Inc., USA, 2017.

⁴³ Arens, A., A.; Edler, R. J.; Beasley, M. S.; Hogan, C. E.: *Auditing and Assurance Services: An Integrated Approach*, 16th Edition, Pearson Education, Inc., USA, 2017, p. 239.

⁴⁴ Arens, A., A.; Edler, R. J.; Beasley, M. S.; Hogan, C. E.: *Auditing and Assurance Services: An Integrated Approach*, 16th Edition, Pearson Education, Inc., USA, 2017, p. 239.

⁴⁵ Arens, A., A.; Edler, R. J.; Beasley, M. S.; Hogan, C. E.: *Auditing and Assurance Services: An Integrated Approach*, 16th Edition, Pearson Education, Inc., USA, 2017, p. 262.

On the other side, “audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk”.⁴⁶ In planning audit engagements auditors determine acceptable level of audit risk, expressed as percentage. “Acceptable audit risk is a measure of how willing the auditor is to accept that the financial statements may be materially misstated after the audit is completed and an unmodified opinion has been issued.”⁴⁷ The practical interpretation of the level of acceptable audit risk is narrowly related with statistics. For example, if auditor accepts overall audit risk at the level of 5% that means that he issues an opinion with 95% certainty that there are no material misstatements in the financial statements. Furthermore, it is practically unfeasible to issue an opinion with 100% certainty, i.e. absolute assurance, considering cost-benefit effects, and time, human and financial resources limitations. But, contemporary information-technology development and digitalization processes, incorporated in continuous auditing, open possibility for auditors to issue absolute, instead of reasonable assurance. “In future, with technological advances, the importance of materiality may reduce as companies and their auditors become able to more cost-effectively, and accurately, interrogate and adjust financial information. However, this is not yet the case.”⁴⁸ “Often, auditors refer to the term audit assurance (also called overall assurance or level of assurance) instead of acceptable audit risk. Audit assurance or any of the equivalent terms is the complement of acceptable audit risk, that is, one minus acceptable audit risk. In other words, acceptable audit risk of 2 percent is the same as audit assurance of 98 percent.”⁴⁹

Audit risk is a function of the risk of material misstatement and the detection risk. While the detection is actually the risk of the auditor that he will not detect material misstatements by conducting audit activities, the risk of material misstatement on the other side is a function of inherent and control risks, where the inherent risk is a function of fraud and business risks. “The risk of material misstatement is the risk that the financial statements contain a material misstate-

⁴⁶ IAASB: Handbook of International Quality Control, Auditing Review, Other Assurance, and Related Services Pronouncements, 2012 Edition, Volume I, ISA 320, A1, p. 317, [https://www.ifac.org/system/files/publications/files/2012%20IAASB%20Handbook%20Part%20I_Web.pdf], accessed on 04/11/2020.

⁴⁷ Arens, A. A.; Edler, R. J.; Beasley, M. S.; Hogan, C. E.: *Auditing and Assurance Services: An Integrated Approach*, 16th Edition, Pearson Education, Inc., USA, 2017, p. 272.

⁴⁸ Financial Reporting Council: Audit Quality Thematic Review: Materiality, 2017, p. 4, [[https://www.frc.org.uk/getattachment/4713123b-919c-4ed6-a7a4-869aa9a668f4/Audit-Quality-Thematic-Review-Materiality-\(December-2017\).pdf](https://www.frc.org.uk/getattachment/4713123b-919c-4ed6-a7a4-869aa9a668f4/Audit-Quality-Thematic-Review-Materiality-(December-2017).pdf)], accessed on 10/11/2020.

⁴⁹ Arens, A. A.; Edler, R. J.; Beasley, M. S.; Hogan, C. E.: *Auditing and Assurance Services: An Integrated Approach*, 16th Edition, Pearson Education, Inc., USA, 2017, p. 272.

ment due to fraud or error prior to the audit. The risk of material misstatement is a function of the susceptibility of the financial statements (as a whole or in individual accounts) to misstatement, and the effectiveness of the client's controls in preventing or detecting and correcting the misstatements."⁵⁰ Auditors assess fraud and business risks in phase of obtaining understanding of the client, and control risk in preliminary controls testing. "When identifying accounts and related assertions at risk of material misstatement, some risks are classified as being more significant than others. A significant risk is an identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration."⁵¹ "Using the audit risk model and performance materiality for each audit objective, the auditor determines the audit evidence needed to achieve an acceptable level of audit risk for the financial statements as a whole."⁵²

How the auditor's report should be read and where do we stand with information needed to understand what is behind an auditor's opinion?

For example, if auditor has issued unmodified opinion, determined materiality level as 2% of total assets, that is 200.000 HRK (total asset is 10 million HRK), and acceptable audit risk is 5%. The independent audit statement should be interpreted as follows: *In our opinion, with certainty of 95%, the accompanying financial statements present fairly, in all material respects, not exceeding materiality of 200.000 HRK for financial statements as a whole, the financial position of X Company as at December 31, 20X1, and its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).* The non-underlined italic part of the sentence present formulation available from the auditor's report, and underlined italic part present additional information that should be considered for obtaining overall, comprehensive conclusion, i.e. the big picture of conducted audit. As it can be concluded, the concepts of materiality and audit risk are mutually conditioned, one measure uncertainty (audit risk) and other measure of magnitude or size of acceptable uncertainty (materiality). The information of acceptable audit risk, without a specific materiality measure, could imply that 10.000 HRK or 1.000.000 HRK misstatements is acceptable, i.e. that auditor gives certain level of reasonable assurance (e.g. 95%) that financial statements as a whole are free from material misstatement in amount *unknown* to users

⁵⁰ Arens, A., A.; Edler, R. J.; Beasley, M. S.; Hogan, C. E.: *Auditing and Assurance Services: An Integrated Approach*, 16th Edition, Pearson Education, Inc., USA, 2017, p. 222.

⁵¹ Johnson, R. N.; Wiley, L. D.: *Auditing: A Practical Approach with Data Analytics*, John Wiley & Sons, Inc., Hoboken, NJ, USA, 2019, p. 3-16.

⁵² Arens, A., A.; Edler, R. J.; Beasley, M. S.; Hogan, C. E.: *Auditing and Assurance Services: An Integrated Approach*, 16th Edition, Pearson Education, Inc., USA, 2017, p. 284.

of financial statements. On the other side, available information on materiality, without information on audit risk, does not provide users with complete information. It is not the same if acceptable material misstatements of 200.000 HRK in case when the level of reasonable assurance is 40% or 95%.

Expectation and Information Gaps

As it can be concluded the statutory auditors have irreparable role in providing reliable and creditable opinion on fair and objective presentation of financial statements of the company. “The external audit plays an important role in supporting the quality of financial reporting around the world, whether in the context of the capital markets, the public sector or the private or non-public sector. It is an essential part of the regulatory and supervisory infrastructure.”⁵³ Auditor’s reporting plays an important role in communication with stakeholders, and by that in 2011 IAASB (standard-setting body) started a process of revision of the *reporting* ISAs with the objective to increase informative value of the independent auditor’s report. “Users recognize there is richer information about the entity and about the audit itself than is currently being provided through the audited financial statements and other corporate disclosure mechanisms, and through the auditor’s report. Users wish to obtain this richer information directly from the entity and/or through communications about the auditor’s insight into such matters. They believe such information would assist them in assessing the financial condition and performance of the entity, as well as the quality of its corporate reporting and the quality of the audit.”⁵⁴ This difference “between what users expect from the auditor and the financial statement audit, and the reality of what an audit is” is known as expectations gap.⁵⁵ As stakeholders are aware that there is much more activities in auditing engagements than publicly presented, they expect and believe that auditor’s report must be more informative, and include additional information that impacted auditors in issuing opinions, but only unified sentence whether financial statements give fair and objective presentation of financial position, business performance and cash flows. “Users of corporate financial information point to

⁵³ IAASB: Enhancing the Value of Auditor Reporting, Consultation Paper, 2011, p. 6, [https://www.ifac.org/system/files/publications/exposure-drafts/CP_Auditor_Reporting-Final.pdf], accessed on 11/11/2020.

⁵⁴ IAASB: Enhancing the Value of Auditor Reporting, Consultation Paper, 2011, p. 7, [https://www.ifac.org/system/files/publications/exposure-drafts/CP_Auditor_Reporting-Final.pdf], accessed on 11/11/2020.

⁵⁵ IAASB: Enhancing the Value of Auditor Reporting, Consultation Paper, 2011, p. 7, [https://www.ifac.org/system/files/publications/exposure-drafts/CP_Auditor_Reporting-Final.pdf], accessed on 11/11/2020.

the existence of a gap between the information they believe is needed to make informed investment and fiduciary decisions, and what is available to them through the entity's audited financial statements or other publicly available information. This 'information gap' has implications for the efficiency of capital markets and the cost of capital."⁵⁶ The IAASB believes that by enhancing the structure and content of individual auditor's report, the information gap will be narrowed and the integrity, reliability and credibility of the report will increase. In 2016 the Board issued five revised (ISA 700 (Revised) *Forming an Opinion and Reporting on Financial Statements*, ISA 260 (Revised) *Communication with Those Charged with Governance*, ISA 570 (Revised) *Going Concern*, ISA 705 (Revised) *Modifications to the Opinion in the Independent Auditor's Report*, and ISA 706 (Revised) *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*) and one completely new reporting standard (ISA 701 *Communicating Key Audit Matters in the Independent Auditor's Report*). The changes significantly upgraded the way auditors report results of conducted audit engagements. Despite significant changes, certain discussed issues are not cover in final proposals. For example, obligation to report applied materiality details. Among other questions and emphasized issues, auditor commentary on matters significant to users' understanding of the audit or the audited financial statements, which would provide increased information about the audit, is that users have suggested that it would be helpful for information to be provided about the level of materiality applied by the auditor to perform the audit.⁵⁷ But they also highlight that is not sufficient to only specify materiality thresholds used by the auditors without explanation of the quantitative and qualitative aspects of the concept of materiality and how it is applied in the audit. Then, in Invitation to Comment – Improving the Auditor's Report, from 2012, on enhancing the informational value of the auditor's report to assist in investment decision-making, users have varying reasons for seeking additional information, and appear to have different views about what may have the most value. In the context of materiality, "others would like to understand more about how the audit was conducted, and key judgments made by the auditor in planning the audit, such as materiality, the use of experts, or the involvement of other auditors"⁵⁸. "A

⁵⁶ IAASB: Enhancing the Value of Auditor Reporting, Consultation Paper, 2011, p. 8, [https://www.ifac.org/system/files/publications/exposure-drafts/CP_Auditor_Reporting-Final.pdf], accessed on 11/11/2020.

⁵⁷ IAASB: Enhancing the Value of Auditor Reporting, Consultation Paper, 2011, p. 17, [https://www.ifac.org/system/files/publications/exposure-drafts/CP_Auditor_Reporting-Final.pdf], accessed on 11/11/2020.

⁵⁸ IAASB: Invitation to Comment – Improving the Auditor's Report (ITC), 2012a, p. 21, [https://www.ifac.org/system/files/publications/files/Auditor_Reporting_Invitation_to_Comment-final_0.pdf], accessed on 11/11/2020.

minority of respondents would also like to know more about other ‘matters of audit significance’, for example matters of audit scope and strategy, including materiality, the use of experts and other auditors.”⁵⁹ Finally, reporting detailed information about materiality is not requested by new and revised ISAs.

So, where do we stand with the two most important concepts of the financial statement audits?

Disclosing the information of the acceptable level of audit risk was not even put into the discussion, and disclosing materiality details, although discussed, was not included in the final version of new and revised reporting International Standards on Auditing. Nevertheless, although not mandatory, recent *Standards* and regulation changes resulted in reporting materiality details by a significant number of auditors in Croatia. In that context, the research question is how that practice develops from the implementation year, 2016, to nowadays, 2020, and what can be expected in the future. Following the research problem, the objective of the paper was to investigate the current state and future perspective of disclosing information regarding materiality in the independent auditor’s report in Croatia.

3. LITERATURE REVIEW

3.1. IMPORTANCE OF MATERIALITY IN CORPORATE GOVERNANCE

The materiality concept, in general, is important from the aspect of the overall financial reporting process and impacts the financial statement quality. There are a significant number of researchers who investigated the importance and the role of disclosing materiality information as a part of integrated reporting.⁶⁰ Integrated reporting is a framework aimed to improve corporate gover-

⁵⁹ IAASB: Auditor Reporting - Summary of Responses Relating to Auditor Commentary, 2012b, p. 1, [https://www.iaasb.org/system/files/meetings/files/20121210-IAASB-Agenda_Item_6A-AR_Auditor_Commentary-final_0.pdf], accessed on 08/11/2020.

⁶⁰ Related research: Mio, C.; Fasan, M.; Costantini, A.: Materiality in integrated and sustainability reporting: A paradigm shift? *Business Strategy and the Environment*, 29(1) 2020, <https://doi.org/10.1002/bse.2390>; Cerbone, D.; Maroun, W.: Materiality in an integrated reporting setting: Insights using an institutional logics framework, *The British Accounting Review*, Elsevier, 52(3) 2020; 14. Green, W. J.; Cheng, M. M.: Materiality judgments in an integrated reporting setting: The effect of strategic relevance and strategy map, *Accounting, Organizations and Society*, Elsevier, 73(C) 2019, pp. 1-14; Gerwanski, J.; Kordsachia, O.; Velte, P.: Determinants of materiality disclosure quality in integrated reporting: Empirical evidence from an international setting, *Business Strategy and the Environment*, Wiley Blackwell, 28(5) 2019, pp. 750-770; Bezverkhyy, K. V.: The Principle of Materiality and Its Practical Implementation in the Integrated Reporting of Corporate Enterprises, *Naukovij Visnik Nacional'noi Akademii*

nance by applying principles focused on cohesion and efficiency to the reporting process “It improves the quality of information available to providers of financial capital to enable a more efficient and productive allocation of capital. Its focus on value creation, and the capitals used by the business to create value over time, contributes towards a more financially stable global economy.”⁶¹ Guiding principles of the framework indicates that the integrated report should “disclose information about matters that substantively affect the organization’s ability to create value over the short, medium and long term”⁶². The integrated report is an unimaginably wider reporting concept compared to financial statements. Next to the financial statements and auditor’s report, it covers strategic reports (organizational overview, business model, risks and opportunities, resource allocation, performance, outlook, basis of presentation) and corporate governance report, i.e. it covers information on internal and external business environment of the company. Reporting materiality, i.e. relevant matters in the integrated report is dominantly qualitative; it describes matters that influence making a business decision by stakeholders. As was stated earlier, materiality is defined by the financial reporting framework. “Materiality is an entity-specific aspect of relevance based on the nature or magnitude, or both, of the items to which the information relates in the context of an individual entity’s financial report.”⁶³ Independent auditors in the planning of financial statement audits have to obtain an understanding of the entity and its environment by performing risk assessment procedures to be able to identify and assess the risks of material misstatement and also assist the auditor in planning the audit and exercising professional judgment and professional skepticism throughout the audit in determining materiality.⁶⁴ For stakeholders that information is ex-

Statistiki, Obliku ta Auditu. 3 2018, pp. 16-33; Lai, A.; Melloni, G.; Stacchezzini, R.: What does materiality mean to integrated reporting preparers? An empirical exploration, *Meditari Accountancy Research*, 25(4) 2017, pp. 533-552. <https://doi.org/10.1108/MEDAR-02-2017-0113>; Fasan, M.; Mio, C.: Fostering Stakeholder Engagement: The Role of Materiality Disclosure in Integrated Reporting, *Business Strategy and the Environment*, Wiley Blackwell, 26(3) 2017, pp. 288-305

⁶¹ International Integrated Reporting Council: The International Integrated Reporting Framework, 2013, [<https://integratedreporting.org/wp-content/uploads/2013/12/13-12-08-THE-INTERNATIONAL-IR-FRAMEWORK-2-1.pdf>], accessed on 10/11/2020.

⁶² International Integrated Reporting Council: The International Integrated Reporting Framework, 2013, [<https://integratedreporting.org/wp-content/uploads/2013/12/13-12-08-THE-INTERNATIONAL-IR-FRAMEWORK-2-1.pdf>], accessed on 10/11/2020.

⁶³ IASB: IFRS Conceptual Framework for Financial Reporting, 2018, p. 15, [<https://incp.org.co/Site/publicaciones/info/archivos/Conceptual-Framework-2018-03042018.pdf>], accessed on 04/11/2020.

⁶⁴ IAASB: International Standard on Auditing 315 (Revised) Identifying and Assessing the Risks of Material Misstatement, 2019, A50, [<https://www.ifac.org/system/files/publica->

tremely important considering that gives significant insight into the auditor's input information and considerations. It can be concluded that every stakeholder in interpreting financial statements should combine materiality information provided by the auditor in an independent auditor's report and entity's material matters disclosed in an integrated report. The statement can be corroborated from the integrity reporting framework perspective, "the information in the financial statements to serve as an anchor or point of reference to which the other information in an integrated report can be related"⁶⁵.

Another instrument aimed to boost corporate governance is an additional report to the audit committee (or supervisory board) prepared by statutory auditors as a result of conducted statutory audits. Following the Regulation, next to the individual auditor's report disclosed to financial statements, statutory auditors shall prepare an additional report with more detail and comprehensive information regarding audit methodology, procedures, and results. Among others, they are required to publish information about the materiality concept. The report is available only to internal stakeholders, as audit committee or supervisory board members, and in the context of external stakeholders, it has no purpose. There is no available research regarding the information value of the additional report for the committee members. The FRC (2017) conducted survey research and found that "17% of the ACCs had neither discussed nor challenged the appropriateness of the level of overall materiality set by the audit team"⁶⁶. In the case of those ACCs that communicated materiality with auditors, almost 70% of committees consider that the overall materiality level set by the audit team is appropriate and 6% of committee members consider that level was set too high. In the case of 8% of committees, the auditors did not share materiality information with them.⁶⁷ In FRC opinion, the audit committee should not have an only supervisory role in the case of statutory auditors, but they should communicate and discuss the materiality level set and evaluate this given their knowledge of the business to determine its appropriateness, challenging the audit team where necessary.

tions/files/ISA-315-Full-Standard-and-Conforming-Amendments-2019-.pdf], accessed on 13/11/2020.

⁶⁵ International Integrated Reporting Council: The International Integrated Reporting Framework, 2013, p. 19, [https://integratedreporting.org/wp-content/uploads/2013/12/13-12-08-THE-INTERNATIONAL-IR-FRAMEWORK-2-1.pdf], accessed on 10/11/2020.

⁶⁶ Financial Reporting Council: Audit Quality Thematic Review: Materiality, 2017, p. 23, [https://www.frc.org.uk/getattachment/4713123b-919c-4ed6-a7a4-869aa9a668f4/Audit-Quality-Thematic-Review-Materiality-(December-2017).pdf], accessed on 10/11/2020.

⁶⁷ Financial Reporting Council: Audit Quality Thematic Review: Materiality, 2017, p. 23, [https://www.frc.org.uk/getattachment/4713123b-919c-4ed6-a7a4-869aa9a668f4/Audit-Quality-Thematic-Review-Materiality-(December-2017).pdf], accessed on 10/11/2020.

Unlike the required elements and information of the additional report, there are no obligations of disclosing materiality information in the final, publicly accessible result of statutory audit – independent auditor's report for public-interest entities operating in Croatia. On the other side, the national International Standards on Auditing UK (ISAs (UK)) published by Financial Reporting Council in the United Kingdom, which are based on the International Standards on Auditing (ISAs), requires reporting materiality details in auditors report. "In the UK auditors issuing extended audit opinions disclose in those reports the materiality adopted in their audit."⁶⁸ Considering that, auditor's reports of UK companies provide a fruitful field for investigating importance or reporting materiality details.⁶⁹ Goh & Lee (2018) investigated if the level of applied materiality determines earnings quality. By analyzing 432 firm-year observations they found that "a lower threshold of materiality level is associated with a higher earnings quality, as measured by lower discretionary accruals, higher accruals quality, and less earnings smoothing, and after controlling for auditor, industry and time fixed effects"⁷⁰. Their findings are significant in the context of materiality concept importance for evaluating the financial position and business performance of companies, wherein the case of lower material threshold stakeholders can more rely on transparency, integrity, and objectivity of the information presented in financial statements. The more important question relates to usefulness and understanding of the meaning of reported materiality details by stakeholders. Related to that, Christensen et al. (2018) studied if reporting materiality makes difference regarding investment decisions for 246

⁶⁸ Financial Reporting Council: Audit Quality Thematic Review: Materiality, 2017, p. 9, [[https://www.frc.org.uk/getattachment/4713123b-919c-4ed6-a7a4-869aa9a668f4/Audit-Quality-Thematic-Review-Materiality-\(December-2017\).pdf](https://www.frc.org.uk/getattachment/4713123b-919c-4ed6-a7a4-869aa9a668f4/Audit-Quality-Thematic-Review-Materiality-(December-2017).pdf)], accessed on 10/11/2020.

⁶⁹ Related research: Iwanowicz, T.; Iwanowicz, B.: ISA 701 and Materiality Disclosure as Methods to Minimize the Audit Expectation Gap, *J. Risk Financial Manag.*, 2019, 12(4), pp. 1-20, doi: <https://doi.org/10.3390/jrfm12040161>; Goh, B. W.; Lee, K. B. J.; Li, N.; Li, D.: Are disclosed auditor materiality thresholds informative of firms' earnings quality? – Evidence from the revised ISA 700 audit report. (2018). *41st Annual Congress of the European Accounting Association, Milan, Italy, 2018 May 30-June 1. Research Collection School of Accountancy*; Christensen, B. E.; Eilifsen, A.; Glover, S. M.; Messier Jr, W. F.: The Effect of Materiality Disclosures on Investors' Decision Making, *Accounting, Organizations and Society*, (6 September 2020, In Press, Corrected Proof) Forthcoming, doi: <https://doi.org/10.1016/j.aos.2020.101168>; Hallman, N.; Schmidt, J. J.; Thompson, A.: *Does Non-GAAP Reporting Result in Less Conservative Auditor Materiality Judgments? Evidence from the U.K.* (March 16, 2018). Available at SSRN: <https://ssrn.com/abstract=3018823> or <http://dx.doi.org/10.2139/ssrn.3018823>.

⁷⁰ Goh, B. W.; Lee, K. B. J.; Li, N.; Li, D.: Are disclosed auditor materiality thresholds informative of firms' earnings quality? – Evidence from the revised ISA 700 audit report. (2018). *41st Annual Congress of the European Accounting Association, Milan, Italy, 2018 May 30-June 1. Research Collection School of Accountancy*, p. 25.

UK and US investors.⁷¹ Their results show that “those participants who read audit reports that disclose audit materiality do not make significantly different investment decisions than investors who do not receive an audit materiality disclosure”⁷². Furthermore, concerning is finding that investors are more ready to invest in a company whose auditor’s report materiality is set at a higher percentage. The authors give two possible interpretations for that: “(1) investors lack a basic understanding of the inherently inverse relationship between audit materiality and audit precision and audit effort or (2) investors perceive the lower level of reported audit materiality to be a signal of increased auditee risk”⁷³. The authors conclude that reporting materiality can be confusing to investors and that it may be helpful to disclose a more detailed explanation of the inverse relationship between audit materiality and audit precision in an auditor’s report.⁷⁴ Nevertheless, the opinion of the authors is that the information value of the financial statements for financially educated users is enhanced by disclosing materiality details. Another perspective of the reporting materiality was observed by Hallman (2018) who concluded that in the case of a lower level of applied materiality, the level of auditors’ rotation is higher.⁷⁵ Further to this, the author concludes that lowering the rigor of the financial statement audit could indirectly affect investors. On the other side, results provided by Iwanowicz & Iwanowicz (2019) show that the implementation of the ISA 701 that regulated disclosing key audit matters and information about materiality

⁷¹ Christensen, B. E.; Eilifsen, A.; Glover, S. M.; Messier Jr, W. F.: The Effect of Materiality Disclosures on Investors’ Decision Making, *Accounting, Organizations and Society*, (6 September 2020, In Press, Corrected Proof) Forthcoming, doi: <https://doi.org/10.1016/j.aos.2020.101168>.

⁷² Christensen, B. E.; Eilifsen, A.; Glover, S. M.; Messier Jr, W. F.: The Effect of Materiality Disclosures on Investors’ Decision Making, *Accounting, Organizations and Society*, (6 September 2020, In Press, Corrected Proof) Forthcoming, doi: <https://doi.org/10.1016/j.aos.2020.101168>, p. 24.

⁷³ Christensen, B. E.; Eilifsen, A.; Glover, S. M.; Messier Jr, W. F.: The Effect of Materiality Disclosures on Investors’ Decision Making, *Accounting, Organizations and Society*, (6 September 2020, In Press, Corrected Proof) Forthcoming, doi: <https://doi.org/10.1016/j.aos.2020.101168>, p. 25.

⁷⁴ Christensen, B. E.; Eilifsen, A.; Glover, S. M.; Messier Jr, W. F.: The Effect of Materiality Disclosures on Investors’ Decision Making, *Accounting, Organizations and Society*, (6 September 2020, In Press, Corrected Proof) Forthcoming, doi: <https://doi.org/10.1016/j.aos.2020.101168>, p. 25.

⁷⁵ Hallman, N.; Schmidt, J. J.; Thompson, A.: *Does Non-GAAP Reporting Result in Less Conservative Auditor Materiality Judgments? Evidence from the U.K.* (March 16, 2018). Available at SSRN: <https://ssrn.com/abstract=3018823> or <http://dx.doi.org/10.2139/ssrn.3018823>.

limited the audit expectation gap.⁷⁶ Next to 159 companies listed on the London stock exchange, the authors analyzed the auditor's report for 158 companies listed on the Warsaw stock exchange. Their findings confirm the premise that, in most cases, auditors tend to report only information that is legally required. In that context, all UK auditor's reports reported materiality details (materiality levels, including benchmark, rates, overall materiality, and some of them provided information such as performance materiality), and only 9,5% of auditors in Poland reported materiality details.⁷⁷ As opposed to that, Deloitte's (2017) results show that materiality details are disclosed in 48% of auditor's reports in the case of 50 Switzerland listed companies.⁷⁸ Furthermore, PwC (2014) found that 47% (8/17) of Dutch public listed entities have disclosed information about materiality.⁷⁹ PwC (2017) voluntarily discloses "additional information about materiality and group scoping in the reports is provided on the financial statements of Singapore Exchange Limited and DBS Group Holdings Ltd. These additional disclosures are required in the UK but are currently not required in Singapore"⁸⁰.

3.2. CHALLENGES THAT AUDITORS FACING IN DETERMINING MATERIALITY

Grosu et al. (2020) investigated the application of obtaining the understanding of the client by auditors in the case of 34 Romanian companies that are listed on the BVB.⁸¹ They emphasize that the applied materiality level is a result of

⁷⁶ Iwanowicz, T.; Iwanowicz, B.: ISA 701 and Materiality Disclosure as Methods to Minimize the Audit Expectation Gap, *J. Risk Financial Manag*, 2019, 12(4), pp. 1-20, doi: <https://doi.org/10.3390/jrfm12040161>.

⁷⁷ Iwanowicz, T.; Iwanowicz, B.: ISA 701 and Materiality Disclosure as Methods to Minimize the Audit Expectation Gap, *J. Risk Financial Manag*, 2019, 12(4), pp. 1-20, doi: <https://doi.org/10.3390/jrfm12040161>, p. 14.

⁷⁸ Deloitte: Benchmarking the new auditor's report: Key audit matters and other additional information, 2017, [<https://www2.deloitte.com/content/dam/Deloitte/ch/Documents/audit/ch-en-audit-benchmarking-auditors-report.pdf>], accessed on 29/08/2018.

⁷⁹ PwC: Plain speaking! Benchmarking the new auditor's report among Dutch listed entities, 2014, [<https://www.pwc.nl/nl/assets/documents/pwc-benchmark-auditors-reporting.pdf>], accessed on 09/11/2020.

⁸⁰ PwC: Enhanced auditor's report: Survey of first year experience in Singapore, 2017, [<https://www.pwc.com/sg/en/publications/assets/enhanced-auditor-report-201709.pdf>], accessed on 10/11/2020.

⁸¹ Grosu, V.; Mateş, D.; Zlati, M.-L.; Mihaila, S.; Socoliuc, M.; Ciubotariu, M.-S.; Tanasă, S.-M.: Econometric Model for Readjusting Significance Threshold Levels through Quick Audit Tests Used on Sustainable Companies, *Sustainability*, 2020, 12(19), pp. 1-32.

the auditor's professional judgment related to earnings management and the importance of the client, influencing audit risk, and overall audit quality.⁸² "The quality of audit in terms of discretionary revenues has worsened during the financial crisis as a result of the tendency for companies to refrain from disclosing their actual economic situation during times of financial crisis."⁸³ Romi (2017) investigated the difference in determining materiality in case of the existence of a community impact.⁸⁴ The author concluded that there exist "a lack of clear guidelines on materiality for SRA, less scrutiny from regulators, and a significantly broader range of intended users to consider, impact auditor assessments of materiality between financial statement and sustainability assurance engagements. While there is no community impact main effect, the difference in auditor materiality assessment is greater when there is no risk of breaching a contract"⁸⁵. Choudhary, et al. (2019) also investigated challenges that auditors facing in determining materiality.⁸⁶ For research purposes, they examined inspection documents that the eight US largest public accounting firms during the period 2005-2015 submitted to the Public Company Accounting Oversight Board (2,150 clients; 4,284 client-year observations). Authors found that each auditor of the big four audited from 15 to 20% of the observations, followed by Grant Thornton (12.5%), BDO (8.7%), McGladrey/RSM (4.2%), and Crowe (3.2%).⁸⁷ "Our calculated materiality ranges are on average three to four times reported materiality values, suggesting that audit professionals are permitted and expected to exercise considerable professional judgment in determining materiality. We find that looser materiality amounts are positively associated with client financial performance and earnings volatility, while stricter judg-

⁸² Grosu, V.; Mateş, D.; Zlati, M.-L.; Mihaila, S.; Socoliuc, M.; Ciubotariu, M.-S.; Tanasă, S.-M.: Econometric Model for Readjusting Significance Threshold Levels through Quick Audit Tests Used on Sustainable Companies, *Sustainability*, 2020, 12(19), p. 7.

⁸³ Grosu, V.; Mateş, D.; Zlati, M.-L.; Mihaila, S.; Socoliuc, M.; Ciubotariu, M.-S.; Tanasă, S.-M.: Econometric Model for Readjusting Significance Threshold Levels through Quick Audit Tests Used on Sustainable Companies, *Sustainability*, 2020, 12(19), pp. 21-22.

⁸⁴ Romi, A. M.: Differences in Auditor's Materiality Assessments When Auditing Financial Statements and Sustainability Reports, *Social and Environmental Accountability Journal*, 37(2) 2017, pp. 149-150, DOI: 10.1080/0969160X.2017.1345799.

⁸⁵ Romi, A. M.: Differences in Auditor's Materiality Assessments When Auditing Financial Statements and Sustainability Reports, *Social and Environmental Accountability Journal*, 37(2) 2017, pp. 149-150, DOI: 10.1080/0969160X.2017.1345799.

⁸⁶ Choudhary, P.; Merkley, K.; Schipper, K.: Auditors' Quantitative Materiality Judgments: Properties and Implications for Financial Reporting Reliability, *Journal of Accounting Research*, 57(5) 2019, pp. 1303-1351.

⁸⁷ Choudhary, P.; Merkley, K.; Schipper, K.: Auditors' Quantitative Materiality Judgments: Properties and Implications for Financial Reporting Reliability, *Journal of Accounting Research*, 57(5) 2019, p. 1312.

ments are associated with contextual factors mentioned in SAB 99 and AU 9312 such as small profits, poorer financial reporting system quality, and new clients.”⁸⁸ “Our evidence indicates auditors do not set materiality thresholds by applying a simple rule of thumb; rather, materiality amounts vary in ways that suggest auditors are both applying judgment within their audit firms’ guidelines and considering contextual factors discussed in authoritative guidance.”⁸⁹

3.3. THE MATERIALITY BENCHMARKS AND THRESHOLDS

The Standards do not prescribe how to and what to choose as a materiality benchmark in particular cases but it gives possible examples for choosing a benchmark. “Examples of benchmarks that may be appropriate, depending on the circumstances of the entity, include categories of reported income such as profit before tax, total revenue, gross profit, and total expenses, total equity or net asset value. “Profit before tax from continuing operations is often used for profit-oriented entities. When profit before tax from continuing operations is volatile, other benchmarks may be more appropriate, such as gross profit or total revenues.”⁹⁰ To be able to choose the benchmark for determining the materiality level, auditors must learn and understand the client’s business and industry. Different stakeholders will be interested in a different perspective of information available from financial statements. For example, creditors will be interested if a company can meet its assets-based loan covenant, investors wonder if they should invest in the company, or shareholders are interested if the company is managing to operate profitable. The auditor should consider the main stakeholder-based by employing its professional judgment to choose the materiality benchmark. “In practice, of course, auditors may not know who all the users are or what decisions they may make based on the financial statements. As a result, applying materiality in practice is a difficult professional judgment.”⁹¹ In determining the benchmark auditor should observe “prior pe-

⁸⁸ Choudhary, P.; Merkley, K.; Schipper, K.: Auditors’ Quantitative Materiality Judgments: Properties and Implications for Financial Reporting Reliability, *Journal of Accounting Research*, 57(5) 2019, p. 1306.

⁸⁹ Choudhary, P.; Merkley, K.; Schipper, K.: Auditors’ Quantitative Materiality Judgments: Properties and Implications for Financial Reporting Reliability, *Journal of Accounting Research*, 57(5) 2019, pp. 1306-1308.

⁹⁰ IAASB: Handbook of International Quality Control, Auditing Review, Other Assurance, and Related Services Pronouncements, 2012 Edition, Volume I, ISA 320, A4, p. 318-319, [https://www.ifac.org/system/files/publications/files/2012%20IAASB%20Handbook%20Part%20I_Web.pdf], accessed on 04/11/2020.

⁹¹ Arens, A. A.; Edler, R. J.; Beasley, M. S.; Hogan, C. E.: *Auditing and Assurance Services: An Integrated Approach*, 16th Edition, Pearson Education, Inc., USA, 2017, p. 234.

riods' financial results and financial positions, the period-to-date financial results and financial position, and budgets or forecasts for the current period, adjusted for significant changes in the circumstances of the entity".⁹² Auditors should be aware that using "low material threshold results in a greater likelihood that an error detected will be deemed as material by the auditors, and consequently, the more extensive audit procedures performed, combined with a lower tolerable misstatement, increases the likelihood of detecting accounting errors and these errors being corrected".⁹³ "Determining a percentage to be applied to a chosen benchmark involves the exercise of professional judgment. There is a relationship between the percentage and the chosen benchmark, such that a percentage applied to profit before tax from continuing operations will normally be higher than a percentage applied to total revenue. For example, the auditor may consider five percent of profit before tax from continuing operations to be appropriate for a profit-oriented entity in the manufacturing industry, while the auditor may consider one percent of total revenue or total expenses to be appropriate for a not-for-profit entity. Higher or lower percentages, however, may be deemed appropriate in the circumstances."⁹⁴

The reason for not including materiality as an obligatory element of an independent auditor's report may be double-natured. From the one side, the question is are auditor ready to disclose such precise information that would give a significant proportion of information to educated stakeholders, or from the other, is it that majority of stakeholders does not understand the materiality concept and that information would only blur information important to them. Neither Croatian Accounting Act, nor European legislation prescribes including materiality details as a mandatory element of the independent auditor's report. However, Regulation (EU) No 537/2014 prescribes that statutory auditors carrying out statutory audits of public-interest entities shall submit an additional report to the audit committee of the audited entity, and among other

⁹² IAASB: Handbook of International Quality Control, Auditing Review, Other Assurance, and Related Services Pronouncements, 2012 Edition, Volume I, ISA 320, A5, p. 319, [https://www.ifac.org/system/files/publications/files/2012%20IAASB%20Handbook%20Part%20I_Web.pdf], accessed on 04/11/2020.

⁹³ Goh, B. W.; Lee, K. B. J.; Li, N.; Li, D.: Are disclosed auditor materiality thresholds informative of firms' earnings quality? – Evidence from the revised ISA 700 audit report. (2018). *41st Annual Congress of the European Accounting Association, Milan, Italy, 2018 May 30-June 1. Research Collection School of Accountancy*, p. 26.

⁹⁴ IAASB: Handbook of International Quality Control, Auditing Review, Other Assurance, and Related Services Pronouncements, 2012 Edition, Volume I, ISA 320, A7, p. 319, [https://www.ifac.org/system/files/publications/files/2012%20IAASB%20Handbook%20Part%20I_Web.pdf], accessed on 04/11/2020.

items, that report shall “disclose the quantitative level of materiality applied to perform the statutory audit for the financial statements as a whole and where applicable the materiality level or levels for particular classes of transactions, account balances or disclosures, and disclose the qualitative factors which were considered when setting the level of materiality”.⁹⁵

Reporting materiality in an independent auditor's report means disclosing details about the used basis for calculating preliminary materiality level, as well as the applied percentage and an absolute materiality value. As a materiality benchmark auditors most often choose profit-before-tax.⁹⁶ Hallman (2018) investigated the difference between auditors that uses GAAP and non-GAAP financial results for the premium companies listed on the London Stock Exchange for the 2013-2014 fiscal years and found that more than 50% “of auditors who rely on ‘profit-before-tax’ as their materiality benchmark use non-GAAP profit before tax, which results in a less conservative audit (via a higher materiality threshold) 92 percent of the time”⁹⁷. “The GAAP items that auditors’ exclude from the materiality benchmark are highly persistent, suggesting that the exclusions are not typically one-time items as is often claimed.”⁹⁸ Deloitte (2017) concluded that 84% of analyzed auditor's reports that have disclosed information on materiality used profit-before-tax as a benchmark with an av-

⁹⁵ Regulation (EU) No 537/2014 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 16 April 2014 on specific requirements regarding statutory audit of public-interest entities and repealing Commission Decision 2005/909/EC, Article 11, 2(h), [<https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32014R0537>], accessed on 04/11/2020.

⁹⁶ Related research: Choudhary, P.; Merkley, K.; Schipper, K.: Auditors' Quantitative Materiality Judgments: Properties and Implications for Financial Reporting Reliability, *Journal of Accounting Research*, 57(5) 2019, pp. 1303-1351; Hallman, N.; Schmidt, J. J.; Thompson, A.: *Does Non-GAAP Reporting Result in Less Conservative Auditor Materiality Judgments? Evidence from the U.K.* (March 16, 2018). Available at SSRN: <https://ssrn.com/abstract=3018823> or <http://dx.doi.org/10.2139/ssrn.3018823>; Financial Reporting Council: Audit Quality Thematic Review: Materiality, 2017, p. 4, [[https://www.frc.org.uk/getattachment/4713123b-919c-4ed6-a7a4-869aa9a668f4/Audit-Quality-Thematic-Review-Materiality-\(December-2017\).pdf](https://www.frc.org.uk/getattachment/4713123b-919c-4ed6-a7a4-869aa9a668f4/Audit-Quality-Thematic-Review-Materiality-(December-2017).pdf)], accessed on 10/11/2020; Deloitte: Benchmarking the new auditor's report: Key audit matters and other additional information, 2017, [<https://www2.deloitte.com/content/dam/Deloitte/ch/Documents/audit/ch-en-audit-benchmarking-auditors-report.pdf>], accessed on 29/08/2018.

⁹⁷ Hallman, N.; Schmidt, J. J.; Thompson, A.: *Does Non-GAAP Reporting Result in Less Conservative Auditor Materiality Judgments? Evidence from the U.K.* (March 16, 2018). Available at SSRN: <https://ssrn.com/abstract=3018823> or <http://dx.doi.org/10.2139/ssrn.3018823>.

⁹⁸ Hallman, N.; Schmidt, J. J.; Thompson, A.: *Does Non-GAAP Reporting Result in Less Conservative Auditor Materiality Judgments? Evidence from the U.K.* (March 16, 2018). Available at SSRN: <https://ssrn.com/abstract=3018823> or <http://dx.doi.org/10.2139/ssrn.3018823>.

erage threshold of 4.9%.⁹⁹ “Profit before tax is considered as one of the most relevant financial indicator for listed companies.”¹⁰⁰ Iwanowicz & Iwanowicz (2019) found that in the case of companies listed on the Warsaw stock exchange auditors most commonly as a materiality benchmark use profit-before-tax, with the most broadly used rate of 4%.¹⁰¹ Authors also found that a significant share of reports prepared by PBT, KPMG, and PwC set their threshold below 5% meaning that “they are even more detailed and conservative”, and on the other side, in the case of EBITDA “Deloitte stands out from the competition by getting close to the upper limit of the threshold”.¹⁰² Those results show why auditors are not prone to disclose materiality details. Non-disclosure provides for auditors ability to determine a high level of materiality meaning that they will have to obtain less audit evidence, and to retain confidence level at high levels, i.e. audit risk is set at low levels. Choudhary, et al. (2019) also found that almost 60% of auditors use pretax income as a materiality benchmark, followed by revenues (less than 20%), net income (less than 10%), and assets (less than 5%).¹⁰³ FRC (2017) found that in three analyzed years (2015-2017) auditors chose a profit-related benchmark in a majority of cases, but they noticed an increase of audits where materiality has been based on an asset measure.¹⁰⁴ They concluded that “the firms’ methodologies typically provide little or no guidance on how to calculate materiality for loss making entities and we have raised this with the firms”.¹⁰⁵ An interesting finding covers the conclusion

⁹⁹ Deloitte: Benchmarking the new auditor’s report: Key audit matters and other additional information, 2017, [https://www2.deloitte.com/content/dam/Deloitte/ch/Documents/audit/ch-en-audit-benchmarking-auditors-report.pdf], accessed on 29/08/2018.

¹⁰⁰ Deloitte: Benchmarking the new auditor’s report: Key audit matters and other additional information, 2017, p. 16, [https://www2.deloitte.com/content/dam/Deloitte/ch/Documents/audit/ch-en-audit-benchmarking-auditors-report.pdf], accessed on 29/08/2018.

¹⁰¹ Iwanowicz, T.; Iwanowicz, B.: ISA 701 and Materiality Disclosure as Methods to Minimize the Audit Expectation Gap, *J. Risk Financial Manag*, 2019, 12(4), pp. 1-20, doi: https://doi.org/10.3390/jrfm12040161.

¹⁰² Iwanowicz, T.; Iwanowicz, B.: ISA 701 and Materiality Disclosure as Methods to Minimize the Audit Expectation Gap, *J. Risk Financial Manag*, 2019, 12(4), pp. 1-20, doi: https://doi.org/10.3390/jrfm12040161, p. 15.

¹⁰³ Choudhary, P.; Merkley, K.; Schipper, K.: Auditors’ Quantitative Materiality Judgments: Properties and Implications for Financial Reporting Reliability, *Journal of Accounting Research*, 57(5) 2019, p. 1306.

¹⁰⁴ Financial Reporting Council: Audit Quality Thematic Review: Materiality, 2017, p. 10, [https://www.frc.org.uk/getattachment/4713123b-919c-4ed6-a7a4-869aa9a668f4/Audit-Quality-Thematic-Review-Materiality-(December-2017).pdf], accessed on 10/11/2020.

¹⁰⁵ Financial Reporting Council: Audit Quality Thematic Review: Materiality, 2017, p. 14, [https://www.frc.org.uk/getattachment/4713123b-919c-4ed6-a7a4-869aa9a668f4/Audit-Quality-Thematic-Review-Materiality-(December-2017).pdf], accessed on 10/11/2020.

that applied performance materiality range from 40 to 75% and clearly trivial thresholds from 0 to 5%. Taking all into account, materiality can be considered as “one of the most important decisions of the audit and thus one of the most valuable information for users of the financial statements”.¹⁰⁶

4. RESEARCH METHODOLOGY AND RESULTS

The IAASB started a six-year-long project entitled ‘Auditors reporting’ to enhance the value of the independent auditor’s reports in the context of diminishing communication and information gaps. To accomplish their objective, they revised five and issue one new International Standard on Auditing. The project resulted in revolutionary changes to the structure and content of the report. The ISAs become effective for audits of financial statements for periods ending on or after December 15, 2016. Next to such a major change of the reporting ISAs, Croatian auditors had to face the implementation of European legislation in the following year included in the new Audit Act from 2017,¹⁰⁷ which affects audits for public-interest entities. Today, four years after implementation, the question is, how did auditors adapted to the new reporting rules, and is the information value of the report enhanced. Additionally, we could argue, if this new, enhanced, and more informative report, after years of existence will become too uniform and standardized. Furthermore, are small auditors more inclined to provide higher-quality reports to earn clients’ trust, as an investment for future audits opportunities? Following the research problem, the objective of the paper is to investigate the current state and future perspective of the new independent auditor’s report. The question is, are Croatian auditors ready to increase reporting quality by disclosing information regarding materiality as a significant measure of audit quality and relevant information for financially educated stakeholders. To investigate our premises, we developed four research hypotheses:

H1: There is no difference in the informative value of independent auditor’s reports prepared by ‘big’ and ‘small’ auditors in Croatia;

H2: Auditors in Croatia are ready to disclose materiality details in independent auditor’s reports on a voluntary basis;

¹⁰⁶ Deloitte: Benchmarking the new auditor’s report: Key audit matters and other additional information, 2017, p. 15, [<https://www2.deloitte.com/content/dam/Deloitte/ch/Documents/audit/ch-en-audit-benchmarking-auditors-report.pdf>], accessed on 29/08/2018.

¹⁰⁷ Audit Act, (Official Gazette number 127/2017), [https://narodne-novine.nn.hr/clanci/sluzbeni/2017_12_127_2873.html], accessed on 04/11/2020.

H3: Croatian auditors follow European practice in choosing benchmark in auditing public-interest entities;

H4: Audit results available in independent auditor's reports are related to applied materiality level.

The research covers individual auditor's reports of Croatian public-interest entities (PIEs) whose securities are listed on the Zagreb Stock Exchange (ZSE)¹⁰⁸ for the period from the first implementation of revised and new ISAs (2016) to the last available year (2019). Overall, we managed to gather data and analyze 474 individual auditor's reports (2016: 126, 2017: 130, 2018: 117, 2019: 101). On average over 40% examined reports refers to entities with the headquarter in the city of Zagreb. Followed by Central Croatia and Dalmatia with the share of slightly over 20% each, then Istria and Slavonia with less than 10% each. On the other side, over 80% of auditors covered by the research are from Zagreb.

Table 1: Structure of the statutory auditors by the number and share of prepared Independent auditor's report for public-interest entities in Croatia from 2016 to 2019

	2016	2017	2018	2019	Total	%
Deloitte	21	26	23	19	89	19
EY	3	11	12	7	33	7
KPMG	13	13	10	11	47	10
PriceWaterhouseCoopers	30	27	24	12	93	20
'Big Four'	67	77	69	49	262	55
BDO Croatia	10	8	10	16	44	9
'Big Five'	77	85	79	65	306	65
Other statutory auditors	49	45	37	34	165	35
Total Individual Audits	126	130	116	99	471	99
Joint Audits	0	0	1	2	3	1
Total	126	130	117	101	474	100

Source: prepared by authors' using publicly disclosed data available at the Zagreb Stock Exchange web, [www.zse.hr], accessed on 20/09/2020.

As can be seen from the Table 1, more than 50% of all independent auditor's reports are prepared by auditors from the pool 'big four', and adding to them another Croatian big player, results in an increase of share to 65% of audited financial statements. It can be noticed that the highest concentration of the

¹⁰⁸ Zagreb Stock Exchange, [https://zse.hr/], accessed on 26/08/2020.

'big four' was in 2017 when they audited financial statements of almost 60% of all listed PIEs. Furthermore, the importance of BDO Croatia increases over analyzed years, and their share of audited reports increased from 6% in 2016 to almost 16% in 2019. Prescribing mandatory rotation in the new Audit Act from 2017¹⁰⁹, which is harmonized with EU auditing Regulation and Directive, resulted in a decrease of concentration on the Croatian audit market. On the other side, de-concentration is related to only one auditor but is not related to other statutory auditors.

Table 2: Median and total value of revenues, assets and employee number of PIEs audited by statutory auditors in Croatia (2016-2019)

	Total assets (millions HRK)	Revenues (millions HRK)	Employees number
Deloitte	659,546	83,193	65,507
EY	245,551	120,055	89,751
KPMG	350,965	57,882	80,049
PwC	479,949	132,665	141,144
BDO	209,087	38,128	57,864
Other	85,576	42,638	72,324
Joint Audit	38,195	8,890	14,440

Source: prepared by authors' using publicly disclosed data available at the Zagreb Stock Exchange web, [www.zse.hr], accessed on 20/09/2020.

Results in Table 2 show that more than 50% of PIEs audited by EY had total assets over 2.7 billion HRK, revenues over 737 million HRK, and employed more than 1,000 employees. If we exclude joint audits, it can be concluded that EY audited the largest listed PIEs in Croatia over the period from 2016 to 2019. On the other side, other 'small' auditors audited financial statements of the smallest listed PIEs in Croatia. Over the four-year-period they audited in total 42.6 billion HRK revenues, compared to 'big five' that audited 431.9 billion HRK revenues. On the individual level, although EY audited the largest PIEs, the PwC audited the greatest proportion of total revenues (over 27%).

¹⁰⁹ Audit Act, (Official Gazette number 127/2017), [https://narodne-novine.nn.hr/clanci/sluzbeni/2017_12_127_2873.html], accessed on 04/11/2020.

4.1. DIFFERENCE IN THE INFORMATIVE VALUE OF INDEPENDENT AUDITOR'S REPORTS PREPARED BY 'BIG' AND 'SMALL' AUDITORS IN CROATIA

As was elaborated in previous chapters, from the standard-setters and regulators' perspective, the quality of the independent auditor's report can be measured by the information provided in the report. Disclosing various significant information on audit methodology, scope, nature of work, and detailed audit results, should narrow the communication gap between auditors and stakeholders, and increase the credibility of auditor's reports. We are stipulating that reports prepared by 'small' auditors are informative as the ones prepared by 'big' auditors. On the other side, reporting extremely important information crucial for understanding the reach of auditor's opinions is not prescribed by the *Standards* or other regulations. In this chapter, we will investigate if auditors are becoming aware of the importance of disclosed information in reports over the years, or they intentionally or accidentally neglecting that fact, and disclose the minimum required elements, and in that context, despite all efforts of the regulators to provide more information to stakeholders, reports are becoming unified and sterile.

To investigate the research problem, we grouped auditors by the number of conducted audits and the size of the PIEs. The determinants of the size are total assets, revenues, and employee number. The size proxy is obtained by principal component analysis. Kaiser-Mayer-Olkin (KMO) test shows that the sampling adequacy for each variable used for calculating size proxy is acceptable (.624), and Bartlett's test of sphericity with the p-value .000 confirms that data can be processed with factor analysis. The first component of the PCA explains 71.867% of the variance. In the next phase, we calculated the average value of the size proxy per the statutory auditor included in the research. Although there is no difference in results, three cases of the joint audit are excluded from the cluster analysis, and one auditor is excluded because of missing data. Finally, 50 auditors are included in the analysis. To identify relatively homogeneous groups of cases based on chosen characteristics (number of conducted audits and PIEs size), we used hierarchical cluster analysis. All tested methods (nearest neighbor, Ward's method, between-groups linkage) by applying squared Euclidean distance resulted in three clusters. Opposed to that, Euclidean distance resulted in more clusters, which is not interesting in the context of this research. Results of the hierarchical cluster analysis benefit us for using k-means cluster analysis to obtain final clustering results.

Table 3: ANOVA table for the k-means cluster analysis

	Cluster		Error		F	Sig.
	Mean Square	df	Mean Square	df		
Number of audits	9026.907	2	10.340	47	873.032	.000
PIEs size proxy	.983	2	.073	47	13.490	.000
The F tests should be used only for descriptive purposes because the clusters have been chosen to maximize the differences among cases in different clusters. The observed significance levels are not corrected for this and thus cannot be interpreted as tests of the hypothesis that the cluster means are equal.						

Source: prepared by authors' using publicly disclosed data available at the Zagreb Stock Exchange web, [www.zse.hr], accessed on 20/09/2020

The results presented in the ANOVA table (Table 3) show that both characteristics used for clustering the auditors are important in the cluster analysis (p-value < .05). However, considering higher F-value numbers of conducted audits had a higher impact compared to the size proxy for assigning to one of the three clusters. These results differ from the results obtained in the research conducted two years ago where cluster analysis resulted in two clusters where one included the 'big four' and BDO, and other all other auditors.¹¹⁰

Table 4: Number of Cases in each Cluster and structure of the clusters

Group	Auditors	Number of auditors	Number of audits	% of audits
1	PwC, Deloitte	2.000	182	38.40
2	EY, KPMG, BDO	3.000	124	26.16
3	Others	45.000	165	34.81

Source: prepared by authors' using publicly disclosed data available at the Zagreb Stock Exchange web, [www.zse.hr], accessed on 20/09/2020

The deciding characteristic in classifying PwC and Deloitte into a separate group is the number of conducted audits over the four-year-period. Overall, they prepared 182 or 38% of all analyzed independent auditor's reports. For further research purposes, we merged the first and second groups into a single group of 'big' auditors. Also, we added joint audits to the group of 'big' auditors.

¹¹⁰ Tušek, B.; Ježovita, A.: The Key Audit Matters as an Element of the Independent Auditor's Report – a Booster to the Corporate Governance. *InterEULawEast: journal for the international and european law, economics and market integrations*, 2018, 5(2), pp. 241-276. doi:10.22598/iele.2018.5.2.9, p. 260.

Table 5: Descriptive statistics on the number of pages, continuous engagement period and number of published key audit matters for listed PIE (2017-2019) group by auditors' size

	Number of pages			Continuous engagement period			Number of KAM		
	MED	AVG	SD	MED	AVG	SD	MED	AVG	SD
Big auditors	6	6.11	1.15	3	4.45	4.11	1	1.5	0.85
Small auditors	5	5.38	1.34	3	5.56	6.52	1	1.26	0.86

Source: prepared by authors' using publicly disclosed data available at the Zagreb Stock Exchange web, [www.zse.hr], accessed on 20/09/2020

Results show that more than 50% of reports prepared by 'big' auditors have 6 and more pages, which is one page more compared to 'small' auditors (Table 5). On the other side, both groups have the same median value of the continuous engagement period, but 'small' auditors have a longer period of continuous engagement with 5.56 years on average with a significant standard deviation of 6.52 years. The result indicates dispersion in the duration of the continuous engagement period. The maximum continuous period for 'small' auditors was 27 years and for 'big' auditors 23 years. Furthermore, 22 reports audited by 'small' auditors, and 25 reports audited by 'big' auditors, show a continuous engagement period longer than 10 years.

Table 6: Frequencies of continuous engagement periods of Croatian statutory auditors per year

Year	Continuous engagement period		Years of appointment							
	Mean	Count	First year	Second year	Third year	Fourth year	Fifth year	Sixth year	Seventh year	Over six years
2017	5.17	130	27	24	10	20	6	6	3	29
2018	4.97	117	26	18	19	6	16	4	4	21
2019	4.31	101	30	22	10	7	3	11	2	12

Source: prepared by authors' using publicly disclosed data available at the Zagreb Stock Exchange web, [www.zse.hr], accessed on 20/09/2020

The average duration of continuous engagement declines over the years. The information is important from the aspect of the required rotation period prescribed by the Croatian Audit Act from 2017. The same auditor may conduct a

statutory audit for the same PIE for a maximum of 7 years including the year of initial engagement.¹¹¹ In accordance with the Regulation (EU), No 537/2014 maximum duration can be extended to 20 years, and on an exceptional basis, additional engagement shall not exceed two more years. In any case, after breaking the engagement, the statutory auditor shall not undertake the statutory audit of the same public-interest entity within the following four-year period.¹¹² As observed by the years, the share of initial engagements increases. In 2019, in 30% of auditor's reports auditor was initially engaged, compared to 2017 where that was 21%. Conducted tests show that there is no statistically significant difference in duration of engagement period between 'big' and 'small' auditors.

Table 7: Mann-Whitney test of differences between 'big auditors' and 'small auditors'

<i>Test Statistics^a</i>			
	Number of pages	Continuous engagement period	Number of KAM
Mann-Whitney U	17742.500	12537.000	21872.000
Wilcoxon W	31272.500	18978.000	35402.000
Z	-5.587	-.342	-2.716
Asymp. Sig. (2-tailed)	.000	.732	.007
a. Grouping Variable: 2group of auditors_code			

Source: prepared by authors' using publicly disclosed data available at the Zagreb Stock Exchange web, [www.zse.hr], accessed on 20/09/2020

Results of the Mann-Whitney U test (Table 7) shows that the distribution of the number of pages in independent auditor's reports prepared by 'big' auditors and 'small' auditors is not the same (p-value is .000), which lead us to the conclusion that 'big' auditors provide more information in their reports compared to 'small' auditors. Furthermore, according to obtained results 'big' auditors disclose more key audit matter compared to 'small' auditors (p-value .000). Next to the fact that 'small' auditors on average reported a lesser number of key audit matters, 18.5% of them did not include key audit matter paragraph in

¹¹¹ Audit Act, (Official Gazette number 127/2017), Article 64, [https://narodne-novine.nn.hr/clanci/sluzbeni/2017_12_127_2873.html], accessed on 04/11/2020.

¹¹² Regulation (EU) No 537/2014 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 16 April 2014 on specific requirements regarding statutory audit of public-interest entities and repealing Commission Decision 2005/909/EC, Article 17, [https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32014R0537], accessed on 04/11/2020.

the report or did disclose the statement “We have determined that there are no key audit matters to report”, or “Except for the matter described in the Basis for Qualified Opinion section we have determined that there are no key audit matters to report”. The positive information is that more than 50% of non-KAM reports are from the first implementation year, 2016.

Table 8: Frequencies of issued opinions between ‘big auditors’ and ‘small auditors’ and Mann-Whitney test of differences between ‘big auditors’ and ‘small auditors’

	Big auditors	Small auditors		Opinion
Adverse Opinion	0	3	Mann-Whitney U	23406.5
Disclaimer of Opinion	1	1	Wilcoxon W	71611.5
Qualified Opinion	82	52	Z	-1.796
Unmodified opinion	227	108	Asymp. Sig. (2-tailed)	0.072
Total	310	164	a Grouping Variable: 2group of auditors_code	

Source: prepared by authors' using publicly disclosed data available at the Zagreb Stock Exchange web, [www.zse.hr], accessed on 20/09/2020

The differences between ‘big’ and ‘small’ auditors also can be view by analyzing issued opinion in independent auditor’s reports (Table 8). The first results of frequencies show that ‘small’ auditors are more prone to express a modified opinion. Most often, they issued a qualified opinion (31.7%). Furthermore, the only three adverse opinions from the sample are issued by the ‘small’ auditors. Nevertheless, the results of the Mann-Whitney U test show that there is no statistically significant difference in issued opinion distributions between ‘big’ and ‘small’ auditors (p-value .072).

Table 9: Descriptive statistics for number of reasons for modifying opinion between ‘big auditors’ and ‘small auditors’

	Mean	Standard Deviation	Median	Mode	Minimum	Maximum
Big auditors	2.1	1.37	2	1	1	8
Small auditors	1.96	1.16	2	1	1	6

Source: prepared by authors' using publicly disclosed data available at the Zagreb Stock Exchange web, [www.zse.hr], accessed on 20/09/2020

Although 'small' auditors issued more modified opinions, on average 'big' auditors provided more reasons for the modification. Differences are notable only in the value of the arithmetic mean, but not in median and mode results (Table 9). The difference between 'big' and 'small' auditors is not significant what is confirmed by the Mann-Whitney U test (p-value is .741).

Table 10: Results of significant going concern disclosure in auditor's reports in Croatia

	Significant going concern disclosure			Other matter paragraph		
	No	Yes	Yes %	No	Yes	Yes %
Big auditors	254	56	18.06	231	79	25.48
Small auditors	144	20	12.20	81	83	50.61

Source: prepared by authors' using publicly disclosed data available at the Zagreb Stock Exchange web, [www.zse.hr], accessed on 20/09/2020

By analyzing differences in disclosing information in the paragraph regarding going concern assumption, it can be noted that 18% of 'big' auditors and 12% of 'small' auditors expressed their opinion regarding going concern assumption (Table 10). Nevertheless, the difference in distributions between 'big' and 'small' auditors is not statistically significant (Mann-Whitney U test p-value is .098).

Table 11: Differences in the informative value of auditor's report between 'big' and 'small' statutory auditors in Croatia (2016-2017)

	Big auditors vs. small auditors	p-value for the Mann-Whitney U test
Number of pages	Difference	.000
Continuous engagement period	No difference	.732
Number of KAM	Difference	.007
Opinion	No difference	.072
Reasons for modifying opinion	No difference	.741
going concern disclosure	No difference	.098
Other matter paragraph	Difference	.000

Source: prepared by authors' using publicly disclosed data available at the Zagreb Stock Exchange web, [www.zse.hr], accessed on 20/09/2020

Considering all together, certain differences between independent auditor's reports prepared by 'big' and 'small' auditors exist (Table 11). Differences arise in the number of pages, reported key audit matters, and inclusion of other matter paragraphs. On the other side, there is no difference in the duration of the continuous engagement period, frequency in reporting modified opinion, and the number of reasons for opinion modification. Furthermore, there is no statistically significant difference in disclosing information regarding going concern assumption. Putting differences on the one, and similarities on the other side, we are concluding that the information value of independent auditor's reports prepared by 'big' and 'small' auditors for Croatian listed PIEs in the period from 2016 to 2019 is the same, and by that, we are accepting our first research hypothesis (H1).

4.2. REPORTING MATERIALITY DETAILS IN INDEPENDENT AUDITOR'S REPORTS

Stakeholders must use materiality and audit risk information to be able to read the auditor's report correctly and comprehensively. From the aspect of the investor, it should not be the same if the tolerable misstatements in financial statements are 1 or 7 million HRK, or if auditors provide the level of reasonable assurance of 85 or 95%. The first step in that direction is to disclose materiality details in independent auditor's reports.

Table 12: Reporting materiality in independent auditor's reports of PIEs in Croatia (2016-2019)

	2016	2017	2018	2019	Total	%
No	96	64	58	50	268	56.54
Yes	30	66	59	51	206	43.46

Source: prepared by authors' using publicly disclosed data available at the Zagreb Stock Exchange web, [www.zse.hr], accessed on 20/09/2020

Out of 474 analyzed independent auditor's reports for the four-year-period, more than half of them do not disclose materiality details (Table 12). The main reason for such a result is the first year of implementation of the revised and new ISAs where even 76% of reports did not have disclosed information regarding materiality details. In the next year, the share of reports that includes materiality details reached 50% and stayed at that level over the following years.

Although over the years it can be noticed the increase of auditors that provide materiality details in their reports, few big players are stubborn, and they disclose minimum of the required information. Results of studies conducted for the entities listed on the UK security market, where reporting materiality is required, show that just those auditors are using the highest level of tolerable misstatements, implying lower audit quality.

Table 13: Reporting materiality in independent auditor's reports of PIEs in Croatia (2016-2019) by auditors' groups

Reporting materiality	No		Yes		Total
	n	%	n	%	
Big auditors	182	58.7	128	41.29	310
Small auditors	86	52.4	78	47.56	164
Total	268	56.5	206	43.46	474

Source: prepared by authors' using publicly disclosed data available at the Zagreb Stock Exchange web, [www.zse.hr], accessed on 20/09/2020

In the first group of the 'big' auditors can be noticed that almost 60% of auditors disclose materiality details in independent auditor's reports (Table 14). In that group, only two statutory auditors disclose given information, and three of them never disclosed materiality details in their reports. Taking altogether into account, the situation with 'small auditors' is better. Over 47% of reports prepared by small auditors disclose materiality information. Furthermore, out of 49 'small' auditors, 28 or 57% of them disclosed materiality details in their reports. Additionally, one auditor, in three reports, disclosed information about performance materiality. Nevertheless, the difference is not statistically significant (Mann-Whitney U test p-value .191). Considering all we can accept our second research hypothesis that statutory auditors in Croatia are ready to disclose materiality details in independent auditor's reports on voluntary basis (H2).

Table 14: Materiality amounts reported in the independent auditor's reports by chosen benchmark

Materiality benchmark	n	% n	Mean	Standard Deviation	Median
Assets	31	15.05	14,147,827	60,544,860	2,055,431
Earnings	38	18.45	21,944,421	25,614,223	11,700,000
Equity	1	0.49	7,550,000	.	7,550,000
Revenues	136	66.02	8,139,576	10,578,611	3,820,000

Source: prepared by authors' using publicly disclosed data available at the Zagreb Stock Exchange web, [www.zse.hr], accessed on 20/09/2020

In the literature review section of the paper, we found that the most often used materiality benchmark by auditors in the EU, UK, and the USA is a profit-before-tax. Over the four-year-period, in only 18% of reports for Croatian listed PIEs that disclosed materiality details, auditors choose earnings as a benchmark, and the majority of them, over 65%, chose revenues (Table 14). The materiality amount always must be observed together with the materiality percentage, but at this point, it can be noticed that in the case where benchmarks are assets or revenues, the materiality amount is lower compared to reports where the benchmark was earnings. That could lead us to the conclusion that auditors of small companies rather choose revenues as a materiality benchmark.

Table 15: Materiality amounts reported in the independent auditor's reports by chosen benchmarks and auditors group

		Count	Mean	Standard Deviation	Median
Assets	Big auditors	8	48,053,330	118,023,620	7,975,000
	Small auditors	22	2,452,286	1,732,657	1,700,000
Earnings	Big auditors	26	28,111,615	27,795,410	16,523,500
	Small auditors	11	6,426,000	11,024,910	550,000
Revenues	Big auditors	91	10,022,813	11,939,932	4,796,000
	Small auditors	45	4,331,251	5,438,663	1,400,000
Equity	Big auditors	1	7,550,000	.	7,550,000
	Small auditors	0	0	0	0

Source: prepared by authors' using publicly disclosed data available at the Zagreb Stock Exchange web, [www.zse.hr], accessed on 20/09/2020

The more detailed results (Table 15) show that the only difference in choosing a benchmark in the case of 'small' compared to 'big' auditors are related to assets. Additionally, 'big' auditors audited the largest PIEs, as shown earlier, and in that context, it is expected that the absolute value of materiality is higher in the case of 'big' auditors. Putting aside a benchmark, correlation analysis for every observation shows the significant positive correlation of materiality amount with the value of PIEs' assets (.839, significant at the 0.01 level), and then revenues (.674, significant at the 0.01 level). The difference in materiality amount reported by 'big' and 'small' auditors is statistically significant (Mann-Whitney U test p-value .000).

Table 16: Materiality percentages reported in the independent auditor's reports by chosen benchmarks

Materiality benchmark	Materiality percentage					
	Mean	Standard Deviation	Mode	Median	Maximum	Minimum
Assets	1.20	0.58	1.00	1.00	3.00	0.50
Earnings	5.76	2.47	5.00	5.00	10.00	2.50
Equity	4.50	.	4.50	4.50	4.50	4.50
Revenues	1.40	0.73	1.00	1.00	5.00	0.05

Source: prepared by authors' using publicly disclosed data available at the Zagreb Stock Exchange web, [www.zse.hr], accessed on 20/09/2020

Results of descriptive statistics show that the most commonly applied percentages of materiality by Croatian auditors are at the same level as worldwide practices. When using earnings as a materiality benchmark, most often they set it at a level of 5%. The average materiality percentage was 5.76% with a standard deviation of 2.47%. The maximum percentage for earnings as a materiality benchmark was 10% and a minimum of 2.5%. The revenues are most often materiality benchmark for Croatian statutory auditors, with an average percentage of 1.40% and a standard deviation of 0.73%. The most commonly used percentage for the revenues was 1%.

Table 17 Differences in materiality percentages reported in the independent auditor's reports by chosen benchmarks and auditors' size

Materiality base / auditors size		Materiality percentage						
		Count	Mean	Standard Deviation	Median	Mode	Minimum	Maximum
Assets	Big auditors	9	1.48	0.66	1	.90a	0.9	2.6
	Small auditors	22	1.09	0.51	1	1	0.5	3
Earnings	Big auditors	27	4.81	1.77	5	5	2.5	9
	Small auditor	11	8.09	2.47	10	10	5	10
Equity	Big auditors	1	4.5	.	4.5	4.5	4.5	4.5
Revenues	Big auditors	91	1.37	0.65	1	1	0.7	3
	Small auditors	45	1.48	0.88	1.3	1	0.05	5
a Multiple modes exist. The smallest value is shown								

Source: prepared by authors' using publicly disclosed data available at the Zagreb Stock Exchange web, [www.zse.hr], accessed on 20/09/2020

Results indicate that ‘big’ auditors prefer earnings as a benchmark, and ‘small’ auditors prefer assets. Nevertheless, Croatian auditors most often apply revenues as a materiality benchmark. For all benchmarks, except assets, ‘small’ auditors set a higher percentage compared to ‘big’ auditors, which implies higher audit quality of ‘big’ compared to ‘small’ auditors. Nevertheless, differences between ‘big’ and ‘small’ auditors are not statistically significant (Mann-Whitney U test p-value .565). Unlike European, UK, and USA practice, auditors in Croatia most often choose revenues as a materiality benchmark, by which we reject our third research hypothesis that Croatian auditors follow European practice in choosing a benchmark in auditing public-interest entities.

In the last part of the research, we investigated auditors that disclosed information on materiality details in an independent auditor’s report. Our premise is that a lower materiality percentage and amount are in direct relation with higher audit quality. In that context, we assumed that auditors, who determined materiality percentage and amount at a lower level in more cases issued a modified opinion, emphasized other matters, or going concern assumption. As it was found earlier, 206 or 43.46% of independent auditor’s report had disclosed details on materiality. Out of 205 registered audit companies in Croatia¹¹³ 52 of them conducted statutory audits for listed PIEs over the four-year-period, and 23 or 44.23% of statutory auditors included in the research never disclosed materiality details in the independent auditor’s reports. The largest of them are Deloitte, KPMG, and EY. Considering that, the final part of the research covers 29 or 55.77% of auditors that disclosed materiality details in their reports.

By applying multiple regression analysis, we tested three assumptions. The assumptions are that dependent variables (modified opinion, emphasized other matters, and going concern assumption) are negatively related to independent variables (materiality percentage and materiality amount scaled by revenues). Obtained models do not result in a high coefficient of determination but are significant in finding the relationship between audit results and applied materiality levels. The low R-square, if the model is significant, could mean that despite noisy and variable data, we could find a trend that indicates that independent variables still provide information about the dependent variable.

¹¹³ Ministry of Finance: Registry of Auditors, [<http://rgfi.fina.hr/RegistarRevizora>], accessed on: 13/11/2020.

Table 18: Multiple regression analysis – overall model results

Model	Dependent variable	R	R2	Durbin-Watson	F	Sig.
1	Modification of opinion	.172	.030	1.634	3.060	.049
2	Other Matter Paragraph	.166	.027	1.820	2.819	.062
3	Going concern	.210	.044	1.643	4.610	.011

Source: prepared by authors' using publicly disclosed data available at the Zagreb Stock Exchange web, [www.zse.hr], accessed on 20/09/2020

Durbin-Watson test in the range of 1.5 to 2.5 is acceptable, and by that, we can conclude that there is no autocorrelation problem (Table 18). Furthermore, variance inflation factors (VIF) at the level of 1.004 confirms to us that there is no multicollinearity problem with our data. Two of three of our models can be interpreted as statistically significant at the significance level of 5%. If we accept a significance level of 10% the third model also can be accepted. Nevertheless, the idea of the models was to detect the existence and direction of the relationship.

Table 19: Multiple regression analysis – independent variables significance

Model	Independent variables	Unstandardized B	Standardized Beta	Sig.
1 Modification of opinion	Materiality percentage	-.031	-.146	.038
	Materiality amount	.274	.083	.234
2 Other Matter Paragraph	Materiality percentage	.002	.010	.891
	Materiality amount	.552	.166	.019
3 Going concern	Materiality percentage	-.035	-.188	.007
	Materiality amount	-.301	-.106	.127

Source: prepared by authors' using publicly disclosed data available at the Zagreb Stock Exchange web, [www.zse.hr], accessed on 20/09/2020

Obtained results confirm us relationship between materiality level and chosen elements regarding audit results available in independent auditor's reports. As we expected, modification of the auditor's opinion is statistically significant

negatively related to the applied percentage of materiality. If the auditor decreases the used materiality percentage, the likelihood of issuing modified opinion increases. The same conclusion can be made in case of including going concern paragraph in auditor's reports. In the latter case, the significance is even more emphasized. It is interesting to notice that modified opinion or going concern is not related to materiality amount, unlike other matter paragraph, which is influenced by materiality amount, but not with percentage. Considering results, we can conclude that audit results are related to the applied materiality level by which we can accept our fourth research hypothesis (H4).

5. CONCLUSION

Next to the risk of material misstatement, the materiality concept is one of the most important concepts in the audit process. Understanding those concepts significantly helps external stakeholders in reading and evaluating audited financial statements. Those concepts give stakeholders insight into auditors' approaches to financial statements audits. If material misstatement and audit risk are set at a lower level, the auditor shall obtain more audit evidence to issue an opinion. Obtaining more audit evidence leads to greater audit quality. The materiality concept provides stakeholder's information of acceptable material misstatements ensuring that audited financial statements do not contain non-tolerable misstatements, above-disclosed amount, in case of unmodified auditor's opinion. The information can be directly related to analyzed results and should help stakeholders in making a business decision. The results of our research show that the majority of statutory auditors in Croatia are ready to disclose materiality details in an independent auditor's report. More than 55% of auditor's reports for listed PIEs prepared by statutory auditors in the period from 2016 to 2019 have disclosed materiality details. There is no difference in disclosing materiality information between 'big' and 'small' auditors in Croatia. Unlike, other countries analyzed in the paper (EU, UK, USA) that prefer to use profit-before-tax as a materiality benchmark, Croatian auditors prefer a revenue-based benchmark with an average percentage of 1.40%. Finally, we found that in case of used lower materiality percentages auditors more often expressed modified opinion and included going concern paragraph in the report. That could lead to the conclusion that auditors are more cautious and take the audit process more seriously if they in the preliminary phase of the audit process determine inherent and control risks at higher levels, which leads to lower materiality levels. We also found that several 'big' auditors in Croatia are not ready to disclose materiality details in their reports and increase its information value. Considering the information value and communication gap we additionally analyze the structure and content of the new independent auditor's

report prepared in accordance with revised and new ISAs as well in accordance with Croatian and EU legislation. In that context, we concluded that Croatian auditors adapted to changes in two waves. Firstly, in the first year of the revised and new Standards application, 20% of reports did not have disclosed key audit matters, which represents the most significant novelty of the report. In the following year, that share was slightly over 6%, but in that year, the auditor had a problem with disclosing information about appointment date and continuous engagement period duration. Over 20% of auditors did not disclose information or they disclosed information about the year of the first appointment, and 2.3% of them did not disclose information on the continuous engagement period. Problem with disclosing information about appointment date until the last analyzed years, but it can be concluded that auditors have complied with other requirements by the Audit Act and Regulation (EU) No 537/2014. Furthermore, we concluded that there is no difference in the informative value of independent auditor's reports for listed PIEs prepared by 'big' and 'small' auditors. Finally, we can conclude that the information value of the independent auditor's report significantly increased by the implementation of revised and new ISAs and the new legislation. But, on the descriptive level, we found that, with years, used sentences and formulations become uniform. The pattern is recognized in reports of one auditor, but also in reports between different auditors. We are not arguing that standardization is something negative, we are encourage it, but also, we advocate the inclusion of more 'personalized' audit-related entity-specific information as materiality details in independent auditor's report.

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