

Financial Audit Report Modifications in Malta**

Peter J. Baldacchino^a, Frank H. Bezzina^b, Norbert Tabone^a, Jean Paul Vassallo^a

Department of Accountancy, Faculty of Economics, Management & Accountancy, University of Malta, Msida MSD2080, Malta

^b Department of Management, Faculty of Economics, Management & Accountancy, University of Malta, Msida MSD2080, Malta

ABSTRACT

This paper analyses the modifications of financial audit reports of Maltese companies between 2005 and 2009. It examines the audit reports of a random sample of 374 limited liability companies registered with the Registry of Companies in Malta. The study shows that the average 2005-2009 modification rate in Malta stood at 22.4%, this representing an increase over previous periods. Most modified reports were noted in the case of private exempt and international trading non-exempt companies. Generally, private exempt companies had their audit report qualified on the basis of a limitation of scope, whilst most international trading companies had their reports qualified on the basis of disagreement with management. Furthermore, the “small company qualification” (which has been long abolished) was still incorrectly being used in Maltese audit reports till 2009. The results therefore show that there is still room for improvement in audit reporting in Malta. Whilst the Big Four audit firms do not appear to have issues in appropriately adhering to audit reporting standards, Maltese smaller audit firms and sole practitioners were found still to be the main cause for inappropriate audit reporting. Towards improvement, the study provides various recommendations including: a more consistent regulatory framework, stricter enforcement of quality assurance, and the reconsideration of the statutory small audit. Such recommendations may also be applicable to other jurisdictions.

ARTICLE INFO

Keywords:
Modified Audit Reports,
Audit Report Qualifications,
Audit Reporting,
Malta.

**Corresponding author:*
peter.j.baldacchino@um.edu.mt
(Peter J Baldacchino)

Article Submitted 16-01-2014
Article Accepted 25-02-2014

**Article previously published in
EJEM 2014, vol 1, No. 1

1. INTRODUCTION

1.1 Malta and its Accountancy Requirements

The Republic of Malta is an island state in the Mediterranean Sea, located circa 93 kilometres to the south of Sicily and 288 kilometres to the east of Tunisia. Malta has been a member of the European Union since 2004 and joined the Eurozone in 2008. It has an area of just over 316 km² and a population of circa 400,000 residents (National Statistics Office, 2010), this rendering it the smallest of the European Union’s member states. Yet, it is one of the fastest growing financial services centres.

The Accountancy Profession in Malta is regulated by the Accountancy Profession Act 1979 (APA, Chapter 281). The Accountancy Board appointed in terms of the Accountancy Profession Act regulates

all aspects of the profession, including advising the Maltese Government on the approval of accounting and auditing standards, ethics and on the issue of guidelines and other services to practitioners.

Companies in Malta are required by the Companies Act 1995 (Chapter 386 of the Laws of Malta) to keep proper accounting records sufficient to give a true and fair view of the company's results and affairs. Companies must also file an annual return and financial statements with the Registrar of Companies. The accounting requirements are similar to those in the UK and in line with the EU Fourth and Seventh Directives.

The Companies Act and the Accountancy Profession Act make International Financial Reporting Standards as adopted by the European Union ("IFRSs as adopted by the EU") the default accounting framework with which companies' financial statements must comply. Certain qualifying companies may however elect to adopt the Accountancy Profession (General Accounting Principles for Smaller Entities) Regulations, 2009 (GAPSE) as their accounting framework. Both quantitative as well as qualitative criteria must be met for a company to qualify for the adoption of GAPSE, which contains a number of measurement simplifications when compared to IFRSs as adopted by the EU.

All companies in Malta (irrespective of their ownership structure, size or business activity) are required to have a statutory audit of their financial statements. Auditors are required by the Companies Act to make a report to the shareholders on the annual accounts examined by them, which is furnished to the shareholders in advance of the annual general meeting. They are required, in accordance with the Companies Act and International Standards on Auditing (ISA), to express an opinion on whether the financial statements prepared by those charged with governance have been properly prepared, in all material respects, in accordance with the Companies Act and IFRSs as adopted by the EU or GAPSE, as applicable, and whether they show a true and fair view of the company's financial position and financial performance and cash flows of the company.

When the auditor has obtained sufficient appropriate audit evidence that the financial statements show a true and fair view, an unmodified audit opinion is issued. Should the auditor fail to obtain such evidence on the financial statements being audited, a modified audit report is issued. Modifications can either be in the form of an emphasis of matter paragraph (which does not affect the auditor's opinion) or a modified auditor's opinion.

1.2 Aim of Study and Paper Structure

This study analyses modified audit opinions issued by Maltese auditors for all locally registered companies between 2005 and 2009. It considers the extent of multiple and repeated qualifications during

the same period and examines any significant relationships between the main types of modified audit opinions and firm-specific variables.

The paper is organised as follows. We start by reviewing the literature on modified audit opinions, after which we highlight the research methods used to collect and analyse the data. We then summarise the research findings and deliberate upon them. We conclude by providing a series of recommendations aimed at improving Maltese financial reporting and audit which may also be applicable to other jurisdictions.

2. LITERATURE REVIEW

2.1. Types of Audit Report Modifications

ISA 705 *Modifications to the Opinion in the Independent Auditor's Report* distinguishes between three types of opinions that may be used by the auditor when modifying the audit opinion:

- i. **Qualified Opinion:** there are two instances where a qualified opinion can be issued. The first instance is when the auditor, after having obtained sufficient appropriate evidence, concludes that the financial statements are materially misstated, where such misstatements are non-pervasive. Alternatively, a qualified opinion is issued when the auditor concludes that sufficient appropriate audit evidence on which to base the audit opinion cannot be obtained. Again, in such circumstances, the auditor concludes that the possible effects on the financial statements, if any, could be material but not pervasive.
- ii. **Adverse Opinion:** the auditor expresses such an opinion when, after having obtained sufficient appropriate evidence, the conclusion reached is that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.
- iii. **Disclaimer of Opinion:** when the auditor is unable to obtain sufficient appropriate audit evidence to the extent that it is deemed that such evidence could be both material and pervasive to the financial statements, a disclaimer of opinion is expressed.

In addition to such types of modified opinions, ISA 706 *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report* deals with circumstances when the auditor should include an emphasis of matter paragraph in the audit report. By adding such a paragraph, the auditor is drawing the users' attention to a matter properly disclosed in the financial statements which, however, the auditor deems fundamental to the users' understanding of the financial statements.

2.2. The Dilemma: To Modify or Not To Modify

Rodgers *et al.* (2009) argue that auditors face a dilemma when forming and expressing an opinion on the financial statements. DeAngelo (1981) argues that the auditor's economic dependence on their clients may ultimately impair the auditor's objectivity in expressing their audit opinion. The findings by Rodgers *et al.* (2009) suggest that the larger the client, the smaller the chance of receiving a warning signal. Rodgers *et al.* (2009) support the findings that the self-fulfilling prophecy proves another predicament for auditors, arguing that an issuance of a warning signal may bring about a client's failure due to the negative impact that such opinion may have on current and potential stakeholders. A modified audit report, more precisely a going concern modification, could bring about a negative impact in the stock market returns.

Rodgers *et al.* (2009) recommend that auditors must not be hesitant in issuing a modified opinion. The auditor should always act in a professional manner and with due professional scepticism when forming the audit opinion. This is important because should an audit client enter bankruptcy proceedings with a clean audit report, stakeholders and society alike will question the worthiness of the auditor. This argument is also reflected in the study by Guiral *et al.* (2010) who opine that at the centre of the financial scandal is the auditor's opinion about a client's ability to continue in existence - an assessment on the company's going concern. The results of Guiral *et al.* (2010) confirm the existence of the auditors' unintentional reluctance to issue qualified audit opinions alerting investors due to their fear of precipitating clients' final bankruptcy. A modification such as a going concern qualification may undoubtedly put the company in question into more problems, as creditors and investors would be more hesitant in lending or investing their funds with that company. Such a qualification may also serve as an early warning to society that the company may not have good prospects for the future and could possibly go into liquidation proceedings.

2.3 Modified Audit Opinions and their impact

Most of the research on modified audit opinions has studied the empirical relationship between a modified audit opinion and stock market reactions (for example, Firth, 1978; Melumad and Ziv, 1997; Ballesta and Garcia-Meca, 2005; Czerkowski *et al.*, 2010). In his study on qualified audit reports and their impact on investment decisions, Firth (1978) concluded that investors react differently to the various types of audit qualifications. The study showed that stock price reactions that took place occurred immediately after the audit reports were released, with prices declining following a qualification. Research on modified audit opinions has also been carried out across different countries and different stock markets. Thus, for example, a study by Ballesta and Garcia-Meca (2005) analysed the relationship between corporate governance and audit qualifications in Spanish listed entities. The

researcher found that companies that are managed by their owners are less likely to receive an audit qualification, as these are more interested in acting in the best interest of the firm. Czernkowski *et al* (2010) studied the extent of audit qualifications in China following the introduction of several regulatory changes. This study analysed 3,128 audit opinions of Chinese listed companies between 1999 and 2003. The findings show a 12.3% modification rate and did not find evidence that modified audit opinions have significant information value to Chinese investors.

Studies on modified audit opinions have also been conducted in Malta. Farrugia (2003) researched qualified audit opinions in Malta between 1997 and 2000 and identified a qualification rate of 19.9%. The findings showed that no public companies received a qualified audit opinion from the selected random sample, which finding was in line with that of Abulizz and Sherer (1990) in respect of UK public companies.

The most common qualification by Maltese auditors identified by Farrugia (2003) was that emanating from a limitation of scope, which arises in those circumstances where the auditor is unable to obtain all audit evidence required to issue an unmodified opinion. The main reason cited for such modifications to the audit opinion was the “Type Six” qualification, a qualification given to small companies which has long been abolished by the auditing standards adopted in Malta. Furthermore, when the results were classified by company type, the results showed that private exempt companies received most of the limitation-of-scope qualifications.

A similar study conducted by Grech (2007) resulted in a qualification rate of 20.8%, which is marginally higher than that found by Farrugia (2003). Again, the most common reason for the issue of a qualified opinion was limitation of scope, therefore continuing the same trend of results as noted in the previous study by Farrugia (2003). There was also a relatively high number of emphasis of matter paragraphs reported, as 11.1% of audit reports from the selected sample were found to include such paragraph – the main reasons for including this paragraph were general going concern issues.

A more recent study focusing on the going concern qualification in Malta by Vella (2011) confirmed the previous trend identified in the study by Grech (2007) where auditors were more inclined towards the addition of an emphasis of matter paragraph rather than issuing a going concern qualification. In fact, from a sample of 100 companies, 13% had an emphasis of matter included in the audit report, whilst it was only 1% that received a going concern qualification. The researcher also found that the companies having an emphasis of matter paragraph included in the auditor’s report continued having such paragraph in subsequent years.

3. METHODOLOGY

The empirical study attempts to answer the following four research questions:

1. What types of audit reports were issued between 2005 and 2009? Did the modified reports vary by company type?
2. What are the particularities of each type of modification?
3. Where there multiple and repeated qualifications?
4. Do significant associations exist between modified auditor's reports and firm-specific variables?

To answer these questions, empirical data was collected from audit reports of active companies registered with the Malta Financial Services Authority (MFSA) as at 31 December of 2004. This is in line with a previous study conducted by Farrugia and Baldacchino (2005). In determining the sample size for this study, we specified a population of 14,453 active companies, a confidence level of 95%, a margin of error of 5%, and a response rate of 50% for categorical variables (de Vaus, 2014). The minimum sample size required was 374 (Lenth, 2014). Using the random sampling technique, a sample of 374 companies was selected for analysis. These consisted of one public company, 304 private companies and 69 international trading companies.

Following the data collection process, the audit opinions on the selected random sample of financial statements were analysed. A set of firm-specific variables ("Company Type", "Small Company", "Type of Industry", "Net Asset Value" and "Company Auditor") were also identified and data was collected to analyse the relationship, if any, between a modification and the aforementioned variables. A company was classified as "small" if it met the small company definition contained in Section 185 of the Maltese Companies Act (1995), which states that a small company is one which, on its balance sheet date, does not exceed the limits of two of the following three criteria: its balance sheet total is less than €2.5 million, turnover is less than €5.1m and the average number of employees during the accounting period does not exceed 50.

In analysing the data, we used counts, relative frequencies and percentages for categorical data. To determine whether observed frequencies were evenly distributed across categories or to determine whether a significant association existed between variables that use the nominal scale of measurement, the Pearson chi-squared test of independence was used .

4. RESULTS

4.1.Types of Audit Reports

The types of audit opinions issued for the selected sample between 2005 and 2009 are summarised in Figure 1. The audit opinions were originally classified under five headings. After excluding 'emphasis of matter' which was an overlapping group, and those which were unclassified since no financial statements were available for inspection during the years being investigated, the remaining financial statements were classified under 3 main categories. The Chi-squared test of independence showed that

the observed frequencies were not evenly distributed across categories ($\chi^2(2) = 1664.23, p < 0.001$). In fact, the vast majority of selected financial statements had an unqualified audit opinion (76.5%), some had a qualified opinion (23.1%), while a few issued adverse opinions and disclaimers (0.4%).

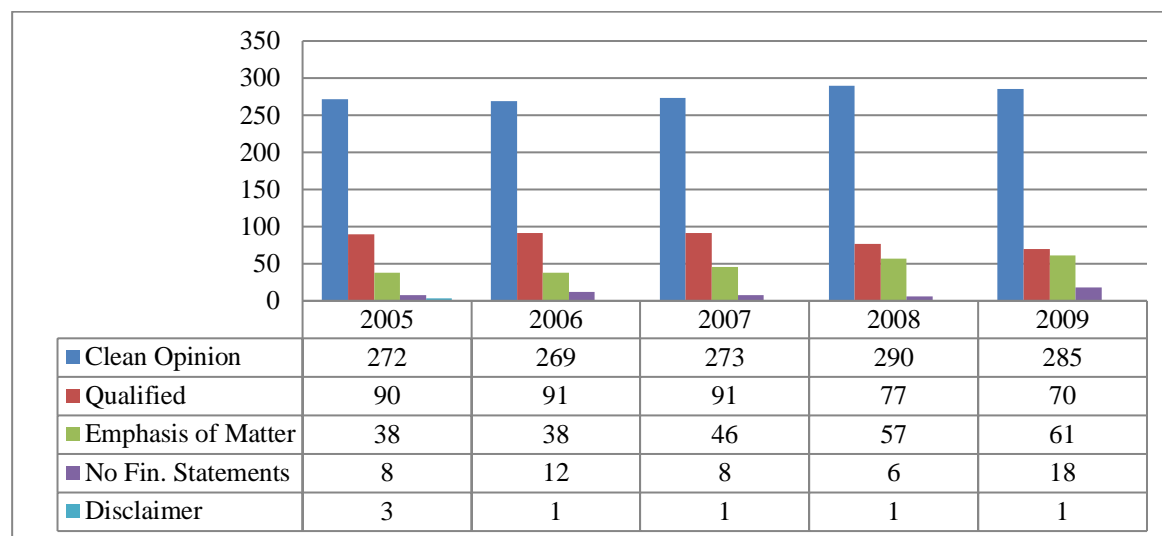


Figure 1: Audit Opinions in Sample by Year (2005-2009)

Audit opinions were subsequently analysed by company type (see Table 1). No modifications were noted for public companies in the five-year period under review. It was found that international trading companies received most of the audit modifications, with non-exempt international trading companies registering the highest average qualification rate (48.3%). The most common issue pertaining to a modification in such companies was a limitation of scope arising out of their small size since there is frequently no distinction between the owner and management.

Table 1: Modifications by Company Type

Company Type	Total number of companies*	Modified Opinion					Five-year average number of qualifications	Average five-year qualification rate (%)
		2005	2006	2007	2008	2009		
ITC non-exempt	41	19	20	21	20	19	19.8	48.3
ITC exempt	28	4	8	9	8	8	7.4	26.4
Private exempt	255	60	55	55	46	36	50.4	19.8
Private non-exempt	49	7	8	6	3	7	6.2	12.7
Total	373	90	91	91	77	70	83.8	22.4

*excludes one public company

4.2. Particularities of each type of Modification

4.2.1. Qualified Opinions

An analysis of the data collected provided further insight on the different types of qualifications that were issued by the auditors (see Table 2). The total number of qualifications shown in Table 2 is not equal to the total number of qualified opinions in the previous tables due to 50 companies receiving a multiple qualification. It is evident from the research findings that limitation of scope and disagreement with management qualifications were the leading cause for qualified audit opinions. Limitation-of-scope qualifications were predominant in private exempt companies, whilst on the other hand, disagreement with management qualifications were mostly identified in the case of international trading companies.

Table 2: Types of Qualified Opinions

Type of Qualified Opinion	Companies with Qualified Opinion by Year					Yearly Average	% of Qualified Opinions
	2005	2006	2007	2008	2009		
Limitation on Scope	58	53	45	33	30	43.8	46.7
Disagreement with Management	25	37	43	45	39	37.8	40.3
Going Concern	19	11	13	8	10	12.2	13.0
Total	102	101	101	86	79	93.8	100.0

Limitation of Scope Qualification

A limitation of scope was mainly prevalent in Maltese private exempt companies. The main cause for the auditors' work being limited in scope was the limited accounting and internal control procedures in client companies. This factor, on its own, accounted for 37.7% of the limitation-of-scope qualifications. Such a characteristic was mostly associated with small private exempt companies which, in view of their limited size and resource availability, may not have proper systems of internal controls.

The inability to attend the stock take or verify the valuation of stock was another leading cause for the auditor's work to be limited in scope (16.9%). A relatively high number of international trading companies had their financial statements qualified due to the inability of auditors to obtain sufficient appropriate audit evidence on opening balances (20.4%). Upon further analysis of the audit reports, it transpired that "general limitation" qualifications were mainly issued by sole practitioners, whose client portfolio generally comprises small and micro companies intrinsically characterised by limited or no controls. The most common cause for a limitation-of-scope qualification was therefore due to inherent

limitations associated with the audit clients where the information supporting an assertion would not be available for audit scrutiny.

Table 3 provides a summary of the main reasons identified for qualifications to the audit opinion attributable to reasons associated with limitations of scope. It is again to be noted that the total number of the qualifications included in Table 3 is not equal to the total number of limitation-of-scope qualifications shown in Table 2 due to instances where companies received a limitation-of-scope qualification on multiple issues.

Table 3: Reasons for Limitation-of-Scope Qualifications

Reasons	Total	Percentage
Limited accounting and internal control procedures	98	37.7%
Unable to verify opening balances	53	20.4%
Unable to verify stock valuation / attend stock take	44	16.9%
Limited controls on / unable to verify cash sales	38	14.6%
Unable to verify valuation of assets	16	6.1%
Unable to verify valuation of expenditure/revenue	9	3.5%
Unable to obtain confirmations on debtors / creditors balances	1	0.4%
Insufficient evidence on significant judgements and estimates	1	0.4%
Total	260	100.00%

Disagreement with Management Qualification

The second most common type of qualification related to issues on disagreement with management. Common issues leading to disagreement with management were “technical issues”, mostly prevalent in international trading companies. The primary cause for such disagreements was the non-disclosure of the ultimate controlling party required by IAS 24 *Related Party Disclosures*. Directors of the latter companies reported that they did not have the appropriate authority to make such disclosure in the financial statements. This issue accounted for 62.8% of the disagreement-with-management qualifications. Non-compliance with IAS 27 *Consolidated and Separate Financial Statements* was another persistent issue in the findings. Over the five-year period under review, this disagreement was noted in 31 instances. This suggests that Maltese companies tend to prefer to take advantage of the exemption offered by local legislation (the Maltese Companies Act, 1995) and have their accounts qualified on this disagreement, rather than being burdened with the cost of preparing consolidated accounts for the sake of receiving an unqualified audit opinion.

An inconsistency with the requirements of auditing standards was also noted in the empirical findings. There were 15 instances where auditors opted to disclose the non-compliance with IAS 24 and IAS 27

as an emphasis of matter paragraph instead of qualifying the auditor's report. The same inconsistency with regards to IAS 27 was also noted in the previous studies by Farrugia and Baldacchino (2005) and Grech (2007).

Another common issue leading to a disagreement with management was inappropriate accounting treatment and departures from IFRS requirements. This led to 53 instances of a disagreement with management qualification. The most common issue (14/53) was the non-compliance with IAS 40 *Investment Property* with respect to the fair valuation of investment property. Issues on accounting for depreciation, where no depreciation was accounted for on property / property improvements, were also surprisingly common in the selected sample (10/53). Non-compliance with IAS 28 *Investments in Associates* was another cause (10/53) for disagreement where companies accounted for such investments using the cost method instead of the equity method as required by this accounting standard.

Going Concern Qualification

The third most common reason for a qualified audit opinion was a going concern issue. 61 instances of going concern qualifications were identified. The basis for qualifying an opinion on going concern is identified in ISA 570 *Going Concern*. However, the majority of auditors expressing such an opinion were not in compliance with the requirements of this standard. It appears that auditors preferred to take a more "prudent" approach by readily qualifying their report on the basis of the applicability of the going concern assumption. In such cases, the wording of the auditor's reports was uncertain, and at times, unclear. For example, most of the going concern qualifications issued were expressed as follows:

"Subject to the applicability of the going concern concept being appropriate, the accounts give a true and fair view of the state of affairs of the company as at..."

Such wording is not acceptable under auditing standards as it is not sufficiently clear or forceful, and is also not in line with the guidance in the relevant auditing standard.

4.2.2. Disclaimers of Opinion

Seven disclaimers of opinion were identified in the selected sample between 2005 and 2009. Six of the disclaimers were issued to private exempt companies, whilst one was issued to an international trading private exempt company.

Three disclaimers were issued to one private exempt company due to the possible effect in the scope of the audit work of the non-consolidated financial statements of the group as required by IAS 27, the non-recognition of a provision for receivables and the close involvement of the director in the company's system of internal control. The company also failed to disclose the identity of its ultimate controlling party as required by IAS 24.

Another private exempt company received three disclaimers of opinion during the period under review. The basis for such disclaimer was the possible significant effects of the limitation on the scope of the audit work. This company did not carry a stock count and the auditor could not obtain sufficient appropriate audit evidence on the valuation of the stock by performing alternative procedures. Furthermore, the auditor was unable to obtain confirmations on debtor balances and there was no system of control over cash sales.

The disclaimer issued to the international trading private exempt company was based on the significance of failing to disclose the identity of the company’s ultimate controlling party as required by IAS 24 and the disagreement with the application of IAS 21 on accounting for the effect of changes in exchange rates.

4.2.3. Adverse Opinions

In the selected sample, only three adverse opinions were identified in the period under review. All three adverse opinions pertained to one company, an international trading private exempt company. In this case, the reporting auditor expressed an adverse opinion as the company did not prepare consolidated financial statements in compliance with the requirements of IAS 27. Such adverse opinions were extremely rare since audit clients would generally be willing to resolve the critical issues possibly leading to such an modification.

4.3. Multiple and Repeated Qualifications

It was observed that 22.8% of the qualified reports had multiple qualifications , as shown in Table 4.

Table 4: Multiple Qualifications by Company Type

	Private Exempt	Private Non-Exempt	ITC Exempt	ITC Non-Exempt	Total
Multiple Qualifications	19	0	4	8	31
Qualified Reports	85	12	11	28	136
% Multiple Qualifications	22.4%	0.0%	36.4%	28.6%	22.8%

This percentage is relatively higher when compared with the multiple qualification rates identified by Grech (2007), Farrugia and Baldacchino (2005) as well as when compared to foreign studies. For instance, Ball et al. (1979) found 15.4% of qualified auditor’s reports with multiple qualifications of which 13.8% were repeated for two subsequent years, while 0.9% were repeated for three subsequent years. The majority of multiple qualifications in this study were due to multiple limitation of scope issues, mostly in private exempt companies. On the other hand, the most common reasons for multiple

qualifications in international trading companies were again the non-compliance with IAS 24 and IAS 27.

The most common reason (7/19) for multiple limitation-of-scope qualifications in private exempt companies was the inability to attend the annual stock-take or verify the valuation of stock, the inability to audit cash transactions and the limited accounting and internal control procedures. Other reasons for multiple qualifications related to the inability to audit opening balances and limited internal controls and procedures (3/19), the non-preparation of consolidated accounts and the non-disclosure of the ultimate controlling party (3/19). On the other hand, international trading companies received most of the multiple qualifications due to the inability to audit comparative balances and the non-disclosure of the ultimate controlling party as required by IAS 24 (8/12).

Most of the multiple qualifications expressed in audit reports of private exempt companies were repeated for two consecutive years (6/19). It was also common for multiple qualifications to be issued for one year (5/19) or repeated for the five years (5/19) in the period under review. A similar trend was noted in international trading companies (both exempt and non-exempt), with multiple qualifications expressed in the audit reports being repeated for at least three years.

An analysis of the frequency of repeated qualifications (see Table 5) showed that limitation of scope and disagreement with management qualifications were be repeated year-in-year-out .

Table 5: Repeated Qualifications

Qualifications repeated for:	Type of Qualification			Total
	Limitation of Scope	Disagreement with Management	Going Concern	
Following year only	14	8	4	26
Two subsequent years	12	7	3	22
Three subsequent years	8	11	4	23
Four subsequent years	19	19	4	42

Common issues for repeated and multiple limitation-of-scope qualifications in private exempt companies were associated with stock valuation and the “small company qualification”. The fact that the “small company qualification” still features in the audit reports for a repeated number of years clearly implies the need for a concentrated effort to obliterate in a definitive manner this non-specific limitation which is no longer permitted by auditing standards.

Big Four audit firms had very few clients with repeated qualifications arising out of fundamental issues while some of their clients had standard technical qualifications arising from the technicalities of

accounting standards, particularly IFRSs. Common examples included the non-consolidation of subsidiaries in view of the exemption granted by the Maltese Companies Act and the non-disclosure of the ultimate controlling party. Non-Big Four auditors had mostly inventory and cash sales leading to repeated qualifications, particularly for small companies having less formal controls. In such cases, the auditor was probably unable to perform the necessary tests year-in year-out, thereby leading to repeated qualifications despite raising the issues for the attention of those charged with governance as part of their audit findings.

Upon comparison with the findings of Grech (2007) and Farrugia and Baldacchino (2005), the repeated qualification rate obtained in this study saw a significant decrease. This is a positive result as it shows that local companies are addressing in a more effective manner the issues identified by their auditors.

4.9. Qualifications and Firm-Specific Variables

The study also sought to analyse whether any particular associations could be established between modified auditor’s reports and firm-specific variables using a series of chi-squared tests. Significant associations were found between:

- auditor type and report qualification ($\chi^2(1) = 8.05, p = 0.005$), where non-Big Four audit reports were less likely to qualify their reports than Big Four audit reports.
- auditor type and compliance of the modified auditor report with the requirements of ISAs over the five years under investigation. It was observed that non-Big Four auditors including sole practitioners were more likely to express audit reports that were not in compliance with the requirements of auditing standards. For instance, in 2009, while Big Four auditors were fully ISA compliant, non-Big Four Auditor were 86.7% compliant, while sole practitioners were only 48.0% compliant ($\chi^2(2) = 11.52, p = 0.021$).
- the repeated qualification and the auditor type ($\chi^2(2) = 7.27, p = 0.026$), where non-Big Four auditors including sole practitioners were more likely to express repeated qualifications than Big Four auditors.
- repeated qualification and company type ($\chi^2(3) = 18.59, p < 0.001$), where international trading companies were more likely to have their qualification repeated when compared to private companies.

5. DISCUSSION

Table 6 shows that there has been an overall increasing trend in the Maltese auditors' qualification rate when incorporating previous studies.

Table 6: Trends in Maltese Auditors’ Reports

Study	Years under review	Average Qualification Rate
-------	--------------------	----------------------------

Farrugia & Baldacchino (2005)	1997-2000	19.9%
Grech (2007)	2001-2004	20.8%
Baldacchino et al. (2014)	2005-2009	22.4%

In this study, no modifications were noted in the case of public limited liability companies. This is consistent with the findings reported by Farrugia and Baldacchino (2005) and Grech (2007) and is justifiable on the basis of the relatively small number of public companies in Malta. The Maltese stock market is a small one and listed companies are few. Given such circumstances, it would be unwise for public companies to publish their financial statements with a modified audit opinion as this could possibly lead to serious consequences within such a small market.

Since most of the registered companies in Malta are considered to be small or micro companies, it is not a surprise that the use of limitation-of-scope qualifications has remained predominant in Maltese audit reports. Such companies, as also identified by Farrugia and Baldacchino (2005), may not have the necessary resources to implement and maintain proper systems of internal control and therefore such a qualification may be inevitable.

It was also noted that the Big Four audit firms issued a lower amount of modified audit reports, and this supports the results reported by Farrugia and Baldacchino (2005).

The findings in this study also indicates a relatively large number of disagreement with management qualifications. When compared with the previous studies of Farrugia and Baldacchino (2005) and Grech (2007), there has been an increase in disagreement with management qualifications, mainly due to inappropriate accounting treatments and departures from accounting standards. This finding implies an increase in the number of companies that are not adhering to the accounting standards identified as constituting best practice and the objective of which is the presentation of true and fair financial information to users for their economic decision making.

Although a decreasing trend was observed in the use of going concern qualifications, the use of such qualification in Maltese audit reports still merits further review. Most of the auditors who expressed a qualification on the basis of going concern did not follow the requirements of the applicable auditing standards and were, at most times, unclear in their opinion. In most of the cases included in the sample, the auditor seemed to adopt a “cautious” or “safe” approach in this regard, possibly as a result of increased quality assurance checks by the regulator (the Maltese Accountancy Board) following various international auditing scandals at the turn of the century. It is clear that auditing standards only require the inclusion of an emphasis of matter paragraph in those cases where, in the auditor’s judgement, the matter (going concern issues) is of such importance that it is fundamental to the users’ understanding of the financial statements. The use of emphasis-of-matter paragraphs should therefore be infrequent; in

the Maltese context, its use is widespread (particularly by sole practitioners) and the risk is that it may often be considered a substitute to an opinion modification.

6. CONCLUSION

This study investigated Maltese audit report modifications during the period 2005-2009 based on an analysis of the statutory audit reports in the financial statements of a representative sample of 374 Maltese companies registered with the MFSA.

The main contribution of this study is that it provides empirical evidence study that the average modification rate not only persisted in the period under review but increased to 22.4%. The study also shows that most modifications were found in private exempt and international trading non-exempt companies. Qualified reports in private exempt companies were generally limitation of scope. It was noted that the small company qualification (which has been long abolished) was still incorrectly being used in Maltese auditor's reports till 2009. Whilst the Big Four audit firms did not appear to have issues in appropriately adhering to audit reporting standards, Maltese smaller audit firms and sole practitioners were found still to be the main originators of inappropriate audit reporting. Furthermore, qualified reports in international trading companies were mainly attributable to disagreement with management commonly due to standard-related issues.

Some limitations to the above findings must be noted. Firstly, the findings are based on the presented audited financial statements lodged at the MFSA, and as evident in Table 1, a number of registered companies failed to present the financial statements for the period under study. Secondly, the study was conducted in economic, legal and political context of Malta, and so its findings and implications may not necessarily lend themselves to generalisation over other country contexts.

Despite these limitations, it is clear that the modification of audit reports has not yet sufficiently contributed to the improvement of Maltese financial reporting. This calls for action on other fronts beyond mere modification. Firstly, Maltese company law needs to be better aligned with international accounting standards, so that the current dilemma of practitioners as to where to stand with respect to the regulatory framework is resolved. Secondly, the study leads us to conclude that a number of auditors, particularly those practising in non-Big Four firms, need to sharpen their audit skills to bring them in line with the required standards. In this context, stricter enforcement of quality assurance by the Accountancy Regulator could be an appropriate first step in this direction. Thirdly, it may be opportune for the accountancy regulator to consider the removal of the statutory audit requirement for small companies given the inherent limitations of such an exercise. This leads to further considerations such as the replacement of the small audit by a review engagement.

In the light of the findings of this study, we feel that it is imperative for the profession to make sure that assurance reports are properly issued in compliance with the applicable standards and that adherence to the a solid regulatory framework is seen as “the means for achieving higher quality levels of performance for the benefit of all stakeholders” (Bezzina et al., 2013).

REFERENCES

Abulizz, S. and Sherer, M. J. (1990), “Qualified audit reports, company size and auditor evidence from the UK”, University of Essex Department of Accounting and Financial Management, Working Paper Series, Nos. 90/91.

Accountancy Profession Act (1979), Chapter 281 of the Laws of Malta, available at: <http://justiceservices.gov.mt/DownloadDocument.aspx?app=lom&itemid=8769> (accessed 12 January 2013).

Accountancy Profession Regulations (General Accounting Principles for Smaller Entities) Regulations (2009), Legal Notice 51 of 2009, Laws of Malta, available at: <http://www.miamalta.org/ELibrary.aspx?elibraryid=37> (accessed 12 January 2013).

Ballesta, J.P.S. and Garcia-Meca, E. (2005), Audit qualifications and corporate governance in Spanish listed firms, *Managerial Auditing Journal*, Vol. 20 No.7, pp.725–738.

Bezzina, F.H., Baldacchino, P.J. and Azzopardi, J.R. (2014), “The Corporate Governance Relationship between the Board and Management in Maltese Listed Companies”, in Tipuric, D., Vrdoljak Raguz, I, & Podrug, N. (Eds.), *Rethinking Corporate Governance* (pp. 1-15), Pearson, Harrow, England.

Companies Act (1995), Chapter 386 of the Laws of Malta, Available at: <http://justiceservices.gov.mt/DownloadDocument.aspx?app=lom&itemid=8853> (accessed 12 January 2013).

Czernkowski, R., Green, W. and Wang, Y. (2010), “The value of audit qualifications in China”, *Managerial Auditing Journal*, Vol. 25, No. 5, pp. 404-426.

DeAngelo, L. (1981), “Auditor Size and Audit Quality”, *Journal of Accounting and Economics*, Vol. 3, pp. 183-199.

deVaus, D. A. (2014), *Surveys in Social Research* (6th ed.), London, Routledge.

Farrugia, K. J. and Baldacchino, P. J. (2005), "Qualified audit opinions in Malta", *Managerial Auditing Journal*, Vol. 20 No. 8, pp. 823-843.

Farrugia, K.J. (2003), *Qualified Audit Opinions in Maltese Audit Reports: An Evaluation*, Unpublished Bachelor of Accountancy (Hons.) dissertation, University of Malta, Malta.

Firth, M., (1978), "Qualified Audit Reports: Their impact on investment decisions", *The Accounting Review*, Vol. LIII No. 3, pp. 642-50.

Grech K.V. (2007), *Recent Trends in Maltese Qualified Audit Opinions*, Unpublished Bachelor of Accountancy (Hons.) dissertation, University of Malta, Malta.

Guiral, A., Rodgers, W., Ruiz, E. and Gonzalo, J. A. (2010), "Ethical Dilemmas in Auditing: Dishonesty or Unintentional Bias?", *Journal of Business Ethics*, Vol. 91, pp. 151-166.

International Federation of Accountants (IFAC), (2009), *ISA 700: Forming an opinion and reporting on financial statements*, available at: <http://www.ifac.org/sites/default/files/downloads/a036-2010-iaasb-handbook-isa-700.pdf> (accessed January 12, 2013).

International Federation of Accountants (IFAC), (2009), *ISA 705: Modifications to the Opinion in the Independent Auditor's Report*, available at: <http://www.ifac.org/sites/default/files/downloads/a037-2010-iaasb-handbook-isa-705.pdf> (accessed January 12, 2013).

International Federation of Accountants (IFAC), (2009), *ISA 706: Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*, available from: <http://www.ifac.org/sites/default/files/downloads/a038-2010-iaasb-handbook-isa-706.pdf> (accessed January 12, 2013).

Lenth, R. (2012), "Java applets for power and sample size", available at: <http://homepage.stat.uiowa.edu/~rlenth/Power/> (accessed 8 February 2012).

Melumad, N. and Ziv, A. (1997), "A Theoretical Examination of the Market Reaction to Auditors' Qualifications", *Journal of Accounting Research*, Vol. 35 No. 2, pp. 239-56.

National Statistics Office (2010), *Demographic Review*, NSO, Malta.

Rodgers, W., Guiral, A. and Gonzalo, J. A. (2009) “Different pathways that suggest whether auditors’ going concern opinions are ethically based”, *Journal of Business Ethics*, Vol. 86, pp. 347-361.

Vella, N. (2011), *Recent Trends in the going concern qualification in Malta: An assessment*, Unpublished Bachelor of Accountancy (Hons.) dissertation, University of Malta, Malta.