



Enhanced auditor reporting: A review of the modified auditor's reports in Georgia

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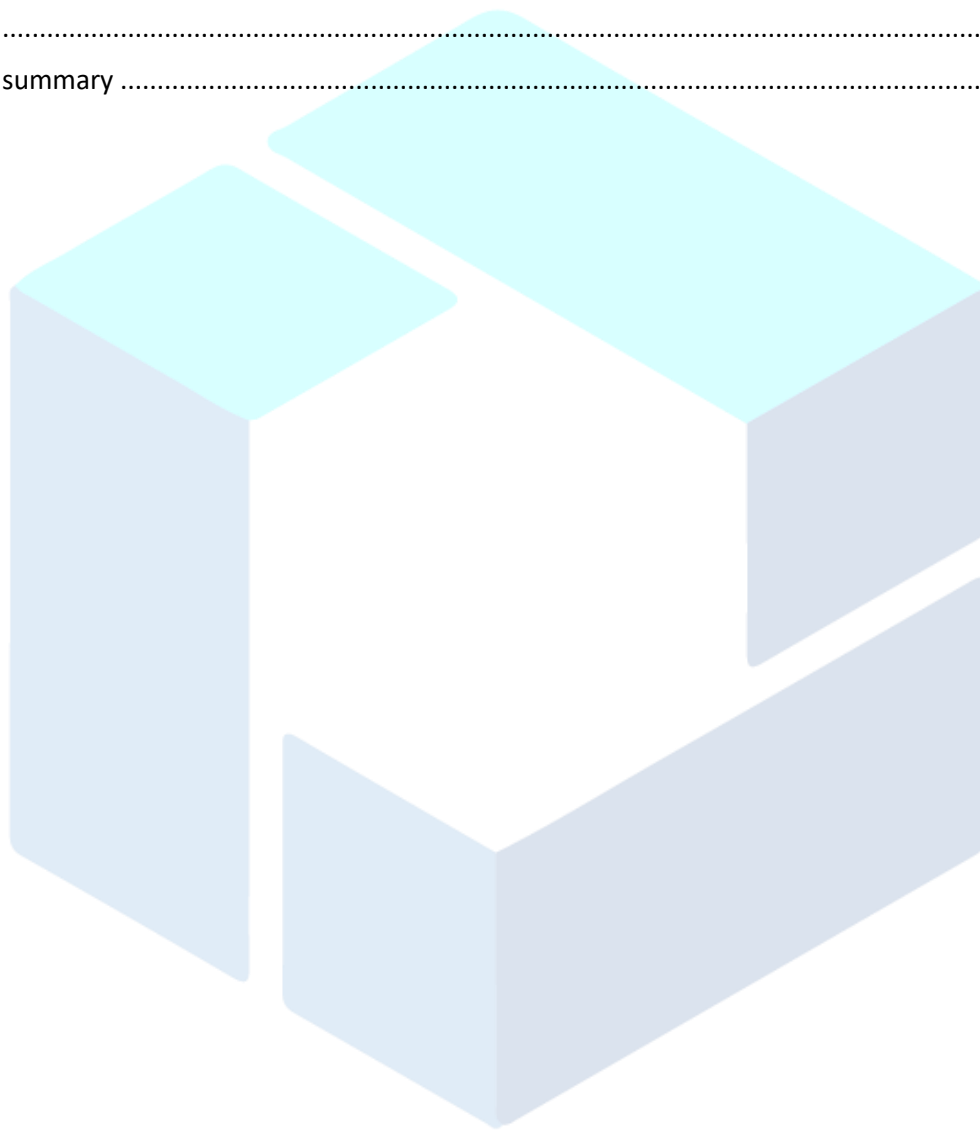
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Introduction

Review

The objective of this report is to review the auditor's reports for the years 2016-2019 in Georgia, focusing on the reporting of key audit matters (KAMs). It includes information on the number and type of KAMs, including those most common. The objective of this report is to review the evolution of the trends in KAM reporting in this four years since being introduced and the possible impacts on quality of audit reports in terms of different audit quality indicators used in measurement as indirect tools.

Submission of Financial Reports became mandatory for Public Interest Entities (PIE) according to the Law of Georgia on Accounting, Reporting and Audit starting from 2016 onwards.

PIEs or the Public Interest Entities are defined as per law of Georgia. As the number of PIEs changes from time to time and it did so in the observed period, in total we assessed in different years information of 162 entities from different sectors of economy shown in the graph below.

Audit firms are the audit firms as per Saras.gov.ge register of audit firms, who have the right of rendering audit services to PIEs and therefore passed quality control procedures. Total number of such companies is 13.

ACKNOWLEDGEMENT: RSF IS GRATEFUL TO THE SPONSORS OF THE PRESENT STUDY EY GEORGIA AND BDO IN GEORGIA AND VALUES THE SUPPORT BY BOTH COMPANIES WHICH HAS HELPED TO IDENTIFY THE AUDIT MARKET RECENT TRENDS AND QUALITY INDICATORS POSSIBLE BOTTLENECKS IN GEORGIA.



Scope of research

For our review, we analyzed all published audit reports to determine what are the trends emerging from the additional reporting entities.

In addition, in our report, we reviewed the revenues and assets of Audit Firms, their clients and audit staff. Determined correlation between the revenue of Audit Firms and the number of their clients.

Also, we reviewed rotation of engaged partners from one year to another in the same companies.

We observed how auditors used the new coronavirus pandemic as a basis for modifying audit findings. Also, whether COVID-19 was mentioned in the aftermath of the reporting period or not.

In this review, we analyzed 421 audit reports issued by the 13 Audit Firms, which have permission for rendering audit for PIEs. All reports were published before the 21st of December, 2020, as follows:

2016 – 53 (being 83% of total PIEs audit reports published for that year)

2017 – 123 (being 87% of total PIEs audit reports published for that year)

2018 – 127 (being 88% of total PIEs audit reports published for that year)

2019 – 118 (being 91% of total PIEs audit reports published for that year)

Legislation

In 2016, The Law of Georgia on Accounting, Reporting and Audit entered into force. The purpose of the Law was to promote financial transparency and economic growth through approximation to the requirements of the relevant European Union directives regulating the reporting and auditing of entities.

The law has required entities of first and second categories as well as PIEs to submit audited financial and managerial reports starting from financial year ended 31st of December 2016 ([Law 2016](#)).

Key Audit Matters: what they are and why they matter

In January 2015, the International Auditing and Assurance Standards Board (IAASB) issued its new and revised auditor reporting standards, which require auditors to provide more transparent and informative reports on the companies they audit. These standards have been issued in response to demand from users of financial statements, in the wake of the financial crisis, for more relevant information on audits.

IAASB issued a judgment-based decision-making framework to help auditors decide which issues from the audit would count as KAMs. Out of all the matters on which they communicated with the company's management and audit committee, they selected KAMs from those matters that required "significant auditor attention." In particular, they should explicitly consider areas where there might be a higher risk of material misstatement or those where significant management or auditor judgments were involved.

Findings by audit firm

Number of audit reports

BDO	KPMG	PKF	EY	Nexia TA	Moore Abc	RSM	PwC	Deloitte	Grant Thornton	Audit- Professional	Baker Tilly	Consaudi	Total
79	56	54	56	46	32	31	21	16	11	9	8	2	421

Number of unmodified (clean) audit opinions

BDO	KPMG	PKF	EY	Nexia TA	Moore Abc	RSM	PwC	Deloitte	Grant Thornton	Audit- Professional	Baker Tilly	Consaudi	Total
40	52	30	53	23	10	11	20	16	0	9	2	0	266

Number of modified audit opinions

BDO	KPMG	PKF	EY	Nexia TA	Moore Abc	RSM	PwC	Deloitte	Grant Thornton	Audit- Professional	Baker Tilly	Consaudi	Total
39	4	24	3	23	22	20	1	0	11	0	6	2	155

Number of KAMs reported by Audit Firms

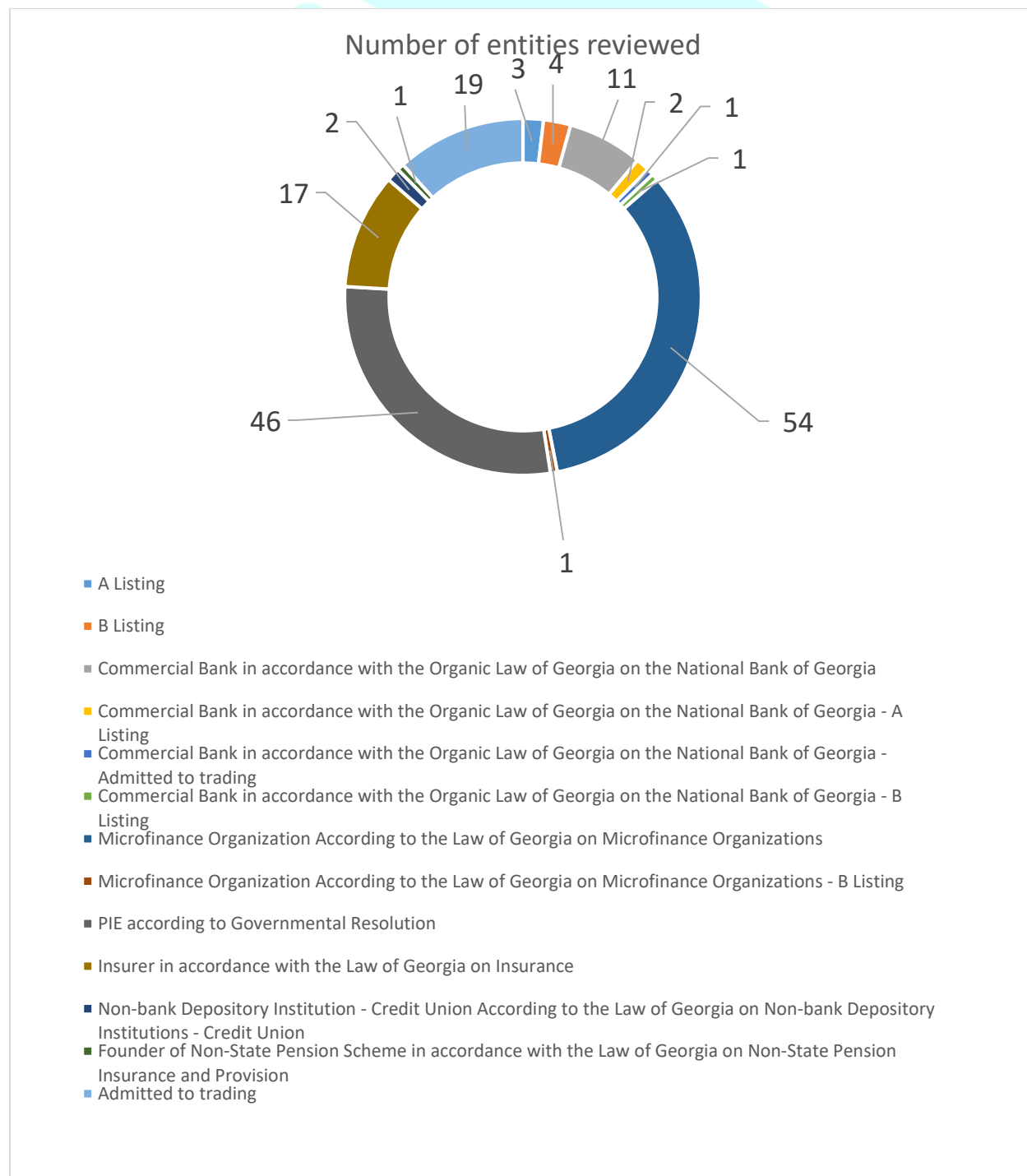
BDO	KPMG	PKF	EY	Nexia TA	Moore Abc	RSM	PwC	Deloitte	Grant Thornton	Audit- Professional	Baker Tilly	Consaudi	Total
62	3	31	3	47	35	24	3	0	18	0	9	2	237

Approach types by Audit Firms

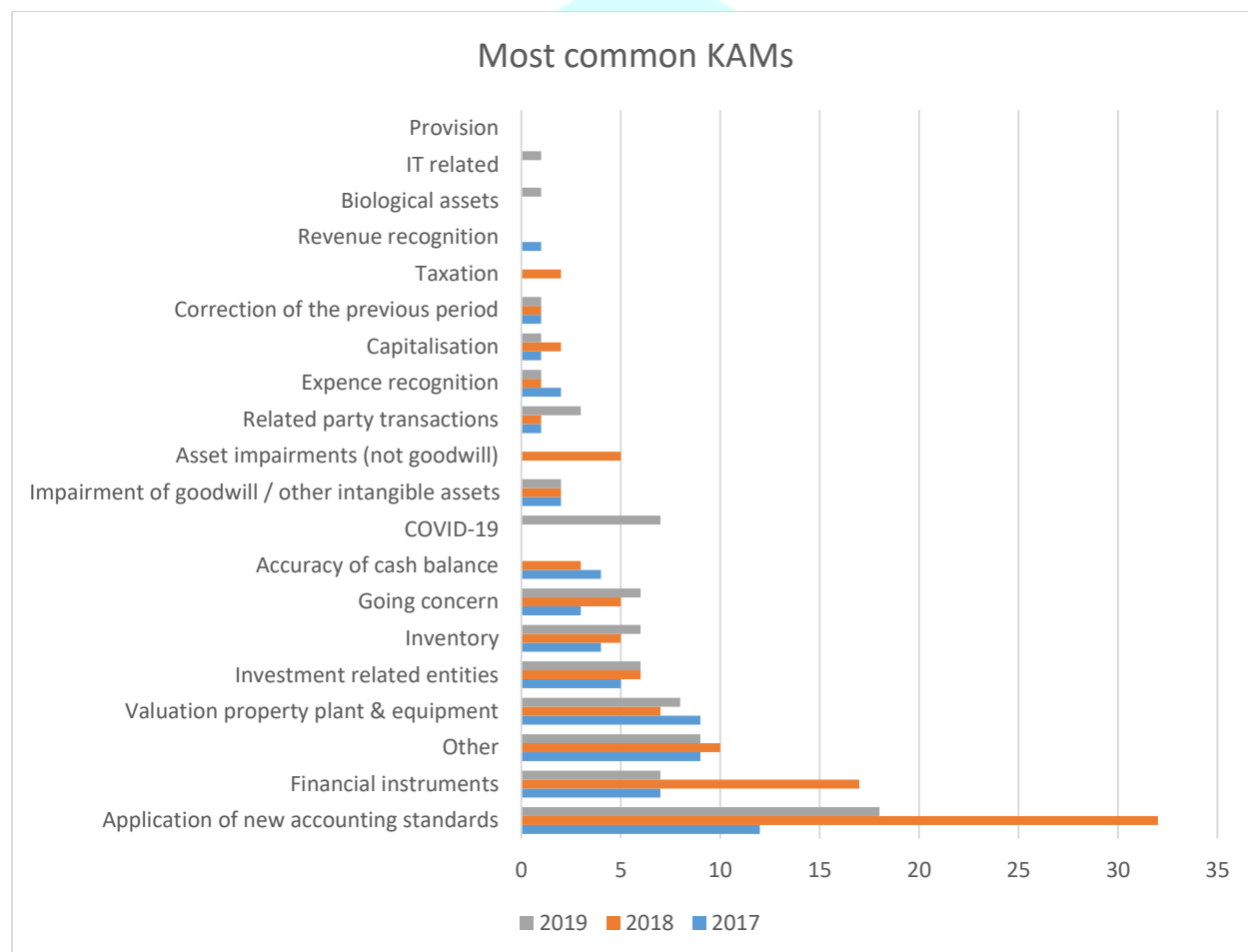
Audit Firms	Unmodified (clean)	Unmodified opinion with a paragraph reflecting other circumstances	Unmodified opinion with a paragraph reflecting significant circumstances	Conditional opinion	Refusal to express an opinion	Negative opinion	Total
BDO	40	-	15	17	6	1	79
KPMG	52	1	2	1	-	-	56
PKF	30	-	-	24	-	-	54
EY	53	-	3	-	-	-	56
Nexia TA	23	-	3	18	2	-	46
Moore Abc	10	-	3	13	2	4	32
RSM	11	3	7	10	-	-	31
PwC	20	-	-	1	-	-	21
Deloitte	16	-	-	-	-	-	16
Grant Thornton	-	-	-	9	-	2	11
Audit- Professional	9	-	-	-	-	-	9
Baker Tilly	2	-	1	5	-	-	8

Consaudi	-	-	-	2	-	-	2
Total	266	4	34	100	10	7	421
In %	63%	1%	8%	24%	2%	2%	100%

PIE entities



The chart below shows the number of KAMs in each main category in 2017, 2018 and 2019 years for 162 PIEs.



While all others are common, among the KAMs we could not find only Insurance Related key audit matter as suggested by similar foreign studies, which means that on Georgian market this matter is not so important.

If we consider KAMs cumulatively in annual perspective in the period of 2017-2019 as well by the function of the impact on leading the report to modification by an Auditor, we get the following results:

	Unmodified opinion with a paragraph reflecting significant circumstances	Conditional opinion	Refusal to express an opinion	Negative opinion	Total
Impairment of goodwill / other intangible assets	-	5	1	-	6



Asset impairments (not goodwill)	1	4	-	-	5
Valuation property plant & equipment	1	20	3	-	24
Revenue recognition	-	1	-	-	1
Expense recognition	1	3	-	-	4
Accuracy of cash balance	-	4	2	1	7
Investment related entities	1	11	5	-	17
Capitalization	1	3	-	-	4
Financial instruments & Provision	-	24	2	5	31
Inventory	-	13	2	-	15
Taxation	1	1	-	-	2
Biological assets	-	1	-	-	1
Application of new accounting standards	1	50	5	6	62
Going concern	8	5	1	-	14
Correction of the previous period	3	-	-	-	3
Related party transactions	4	1	-	-	5
Other (non-compliance with the supervision and regulation norms)	10	16	2	-	28
IT related	7	-	-	-	7
COVID-19	-	-	1	-	1

The top three category have not changed since 2017.

Application of new accounting standards was the most common KAM reported. This KAM was mainly fixed in Microfinance Organization According to the Law of Georgia on Microfinance Organizations (87%). Application of International Financial Reporting Standards (IFRS) as required by the Law starting from 2016, and, as we can observe it became the biggest challenge for entities.

The second most common type of KAM is **Financial instruments** in the same Microfinance Organization According to the Law of Georgia on Microfinance Organizations sector. This sector representing 87% of this KAM. Mainly auditors where mentioning wrong classification and measurement of financial assets as it required by IFRS 9. The same sector is leading in KAM **Other**, which consists non-compliance with the National Bank's supervision and regulation norms.



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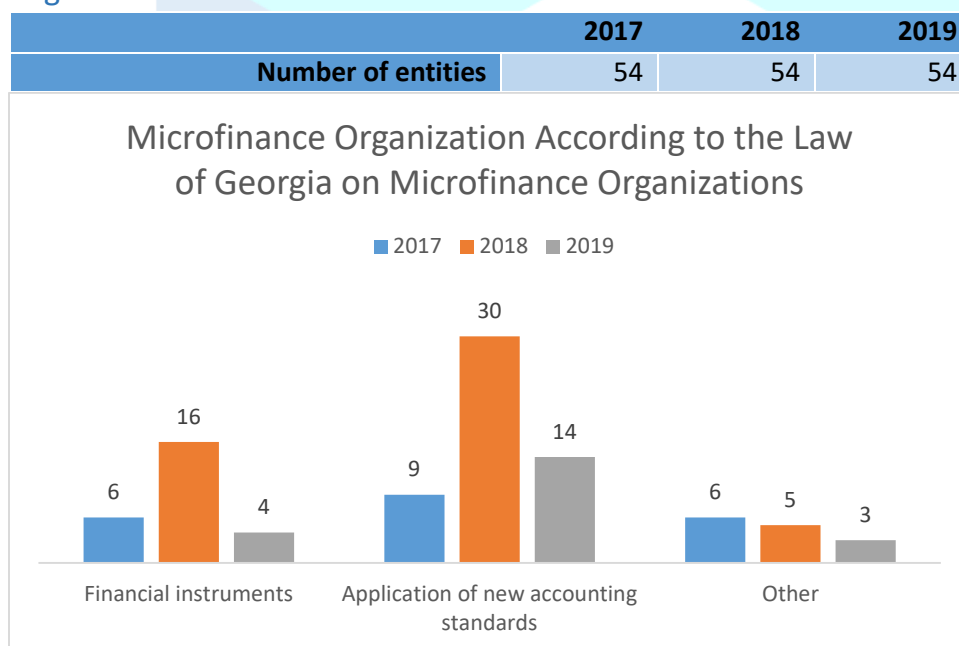
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Valuation of property, plant and equipment was the most common type of KAM in the PIE according to Governmental Resolution sector, representing 83% of KAM reported in this sector. This is an area of judgment requires auditors to challenge the assumption of management and experts when determining the value of investment properties and properties under construction.

KAMs by sector

Overall, the analysis shows that there are three sectors which are problematic in case of KAMs:

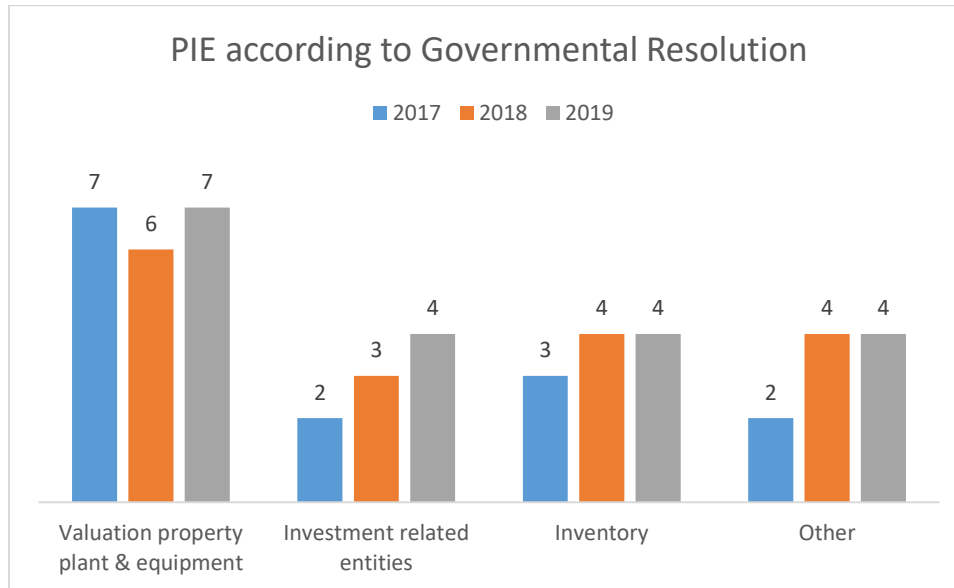
Microfinance Organization According to the Law of Georgia on Microfinance Organizations



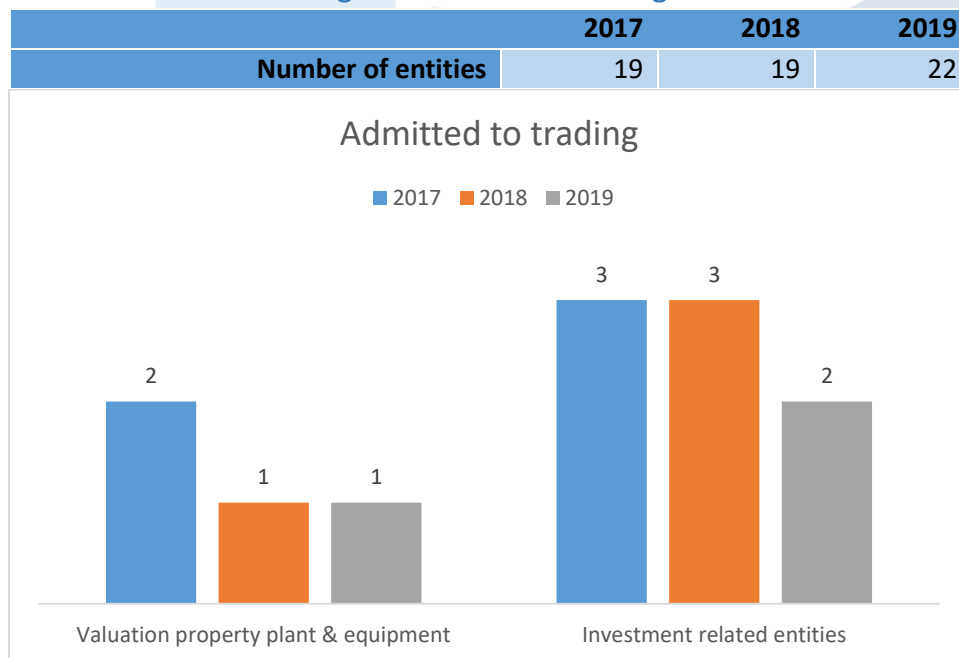
PIE according to Governmental Resolution

	2017	2018	2019
Number of entities	46	46	49

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PIEs Admitted to trading on GSE Stock Exchange



This sector is different from A and B listings, where there are stricter regulatory requirements. 'Admitted to Trading' companies are often those companies which have the right to trade their securities on the stock exchange but actually don't do so because they don't pass the regulatory requirements by GSE.



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Banking Sector

Our review included 15 Commercial Banks. All are in accordance with the Organic Law of Georgia on the National Bank of Georgia.

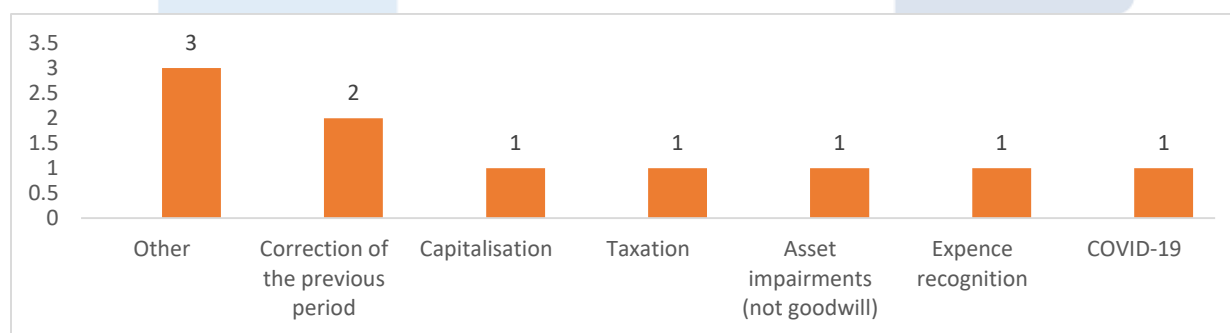
Only two KAMs accrues during our research, both in 2019 reports.

One KAM was **Correction of the previous period** which was mentioned as unmodified opinion with a paragraph reflecting significant circumstances. Second KAM, **Related party transactions** was described as a significant concentration of the Bank's transactions with related parties.

Insurance Sector

Our review included 18 Insurers in accordance with the Law of Georgia on Insurance.

The average number of KAMs reported was three. All in unmodified opinion mentioned in paragraph reflecting significant circumstances. Most common was **Other** - non-compliance with the supervision and regulation norms (3 KAMs). Following by **Correction of the previous period** (2 KAMs).



Going concern as a KAM

Matters related to going concern may be determined to be KAM. A material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern is, by its nature, a KAM.

There are two different communication approaches where the audit opinion is not modified but the auditor still reporting concern matters.

Reporting approach	Going concern	
	Unmodified	Modified
2017	2	1
2018	2	3
2019	4	2

Research shows, that auditors use following events as a KAM of going concern:

- Financial performance of the entity
- The possibility of termination of funding
- Current liabilities exceed current assets

- Entities ceasing operations.

Audit Firms Analysis

Number of audits conducted

The below table shows the total number of submitted PIEs audit reports by years.

Audit Firms	2019 financial year	2018 financial year	2017 financial year	2016 financial year	Total:
PwC	8	5	6	2	21
Deloitte	3	5	5	3	16
EY	16	16	13	11	56
KPMG	15	16	19	6	56
Grant Thornton	3	2	4	2	11
Baker Tilly	2	3	3	0	8
BDO	25	24	21	9	79
Consaudi	0	0	1	1	2
RSM	6	6	11	8	31
Nexia TA	15	18	12	1	46
PKF	14	19	17	4	54
Moore Abc	10	10	8	4	32
Audit-Professional	1	3	3	2	9
	118	127	123	53	421

Percentage change in the number of PIEs audits conducted

Audit Firms	2019 financial year	2018 financial year	2017 financial year
PwC	160%	83%	300%
Deloitte	60%	100%	167%
EY	100%	123%	118%
KPMG	94%	84%	317%
Grant Thornton	150%	50%	200%
Baker Tilly	67%	100%	0%
BDO	104%	114%	233%
Consaudi	0%	0%	100%
RSM	100%	55%	138%
Nexia TA	83%	150%	1200%
PKF	74%	112%	425%
Moore Abc	100%	125%	200%
Audit-Professional	33%	100%	150%

Annual Income

The below table shows the aggregated annual income in Georgian Lari of Audit Firms by years.

Audit Firms	2019	2018	2017	Total:
PwC	8,880,175	7,680,380	5,997,471	22,558,026
Deloitte	3,373,042	4,730,084	3,429,409	11,532,536
EY	10,379,197	8,155,686	7,656,498	26,191,381
KPMG	6,414,222	6,462,345	4,374,806	17,251,373
Grant Thornton	1,202,419	1,193,690	799,214	3,195,323
Baker Tilly	758,905	609,271	554,831	1,923,007
BDO	5,678,808	4,648,692	2,698,956	13,026,456
Consaudi	128,712	174,819	87,806	391,337
RSM	1,225,850	1,125,497	543,811	2,895,158
Nexia TA	1,479,774	1,029,842	408,978	2,918,594
PKF	1,350,762	808,736	271,947	2,431,445
Moore Abc	345,432	287,041	80,599	713,072
Audit-Professional	28,644	28,644	18,644	75,932

Percentage change in Aggregated Annual Income:

Audit Firms	2019	2018
PwC	116%	128%
Deloitte	71%	138%
EY	127%	107%
KPMG	99%	148%
Grant Thornton	101%	149%
Baker Tilly	125%	110%
BDO	122%	172%
Consaudi	74%	199%
RSM	109%	207%
Nexia TA	144%	252%
PKF	167%	297%
Moore Abc	120%	356%
Audit-Professional	100%	154%

Correlation

Correlation between percentage changes in the number of audits conducted and percentage change of Annual Income shown is 0.38 for the year 2018 and 0.64 for 2019. We don't have comparable figure for 2020 income which will come only in 2021.

A value of 0.38 for 2018 means there is still a low positive correlation. The value increase in the next year to 0.64 means that correlation is still positive and became moderate. The idea is that the number of the

PIEs audit reports increase shall be correlated with the aggregated income increase from audit services in order to observe the audit quality on the secured side.

Number of staff in Audit Firms and number of staff per reported PIE audit

The below table shows the number of staff in Audit Firms and number of staff per reported audit:

Audit Firms	Number of staff			Average Number of staff per reported audit		
	2019	2018	2017	2019	2018	2017
PwC	68	60	56	9	12	9
Deloitte	42	41	34	42	8	7
EY	139	131	141	10	8	11
KPMG	68	57	55	5	4	3
Grant Thornton	25	25	25	13	13	6
Baker Tilly	18	15	11	9	5	4
BDO	53	48	35	2	2	2
Consaudi	8	8	6	0	0	6
RSM	36	34	25	6	6	2
Nexia TA	44	36	20	3	2	2
PKF	15	18	12	1	1	1
Moore Abc	14	12	9	1	1	1
Audit-Professional	5	4	4	5	1	1

As we see from this table while some companies show high number of audit firm personnel, other companies show very low level of human resources available, which possibly shall be correlated with the audit quality. Of course there might be not simple direct correlation as for some of the companies the high number of average number of staff per reported audit is only due to low number of reported audits itself. But besides this we believe that this is something to which the audit firms need to pay more attention.

Audit Partners in PIEs

Audit Firms	Total number of audit partners	Number of audit partners where their office referred is their main job	Number of audit partners where their office referred is not their main job	Engagement partners	Engagement partners where their office referred is the main job	Number of partners with shares	Audit partners total shares	Number of engagement partners with shares	Engagement partners total shares
BDO	5	5	0	3	3	3	81%	2	45%
KPMG	3	3	0	2	2	0	0%	0	0%

PKF	4	1	3	4	1	1	75%	1	75%
EY	9	9	0	5	5	4	51%	4	51%
Nexia TA	3	3	0	3	0	1	42.85%	1	42.85%
Moore Abc	3	3	0	2	2	2	55%	2	55%
RSM	4	2	2	3	2	1	100%	1	100%
PwC	10	10	0	3	3	0	0%	0	0%
Deloitte	5	5	0	2	2	0	0%	0	0%
Grant Thornton	3	3	0	3	3	1	10%	1	10%
Audit-Professional	4	4	0	3	3	3	80%	2	55%
Baker Tilly	3	3	0	2	2	3	66%	2	56%
Consaudi	5	5	0	3	3	2	100%	1	50%
Average	5	4	0	3	2	2	51%	1	42%

As we see for some companies their audit partners don't have any shares in the firms, which means that the structure of the firm especially in regards to international networks is based on the Mother company ownership of the shares. So even in this case the minimum threshold of the auditors holding not less than 51% of the voting shares is met. However, what is more important for some companies we see the large number of audit partners, despite of its low number in general, who are listed on the SARAS portal without taking any active role in the audit engagements conducted by the firms, which is a possible sign of audit quality concerns.

Audit Partners Rotation in PIEs

Rotation for key audit partners for audits of public interest entities (PIEs) required by the IESBA Code of Ethics for Professional Accountants. In this review, we analyzed the number of audit partners' rotations in Audit Firms by the years.

Audit Firms	Changed			Not changed		
	2017	2018	2019	2017	2018	2019
BDO	2	-	-	6	20	23
KPMG	-	10	-	3	5	13
PKF	-	2	2	4	13	11
EY	4	1	3	6	11	11
Nexia TA	1	-	-	-	12	10
Moore Abc	-	-	-	3	8	8
RSM	-	-	-	6	6	5
PwC	-	-	-	1	4	4
Deloitte	-	3	1	3	1	2
Grant Thornton	-	-	-	2	2	2

Audit-Professional	-	-	-	2	3	1
Baker Tilly	-	-	-	-	2	2
Consaudi	-	-	-	1	-	-
Total:	7	16	6	37	87	92

So as we see the number of partner's rotation in the audit firms per engagements with specific PIEs is very low. This is due various facts, first of all it shall be mentioned low number of active engagement partners in the audit firms, and secondly and importantly they don't change from year to year, at least we lack to observe such situation. It shall be noted that for some companies compare to others such situation is less dramatic.

In a yearly perspective we can trace the tendency of changing or not changing the auditors' opinions from modified to unmodified (clean) with the same clients compare to previous year reports.

Audit Firms	2017 financial year			2018 financial year			2019 financial year		
	Changed opinion to previous year from modified to unmodified (clean) by		Opinion has not been changed to previous year	Changed opinion to previous year from modified to unmodified (clean) by		Opinion has not been changed to previous year	Changed opinion to previous year from modified to unmodified (clean) by		Opinion has not been changed to previous year
	same Audit firm	Audit firm changed		same Audit firm	Audit firm changed		same Audit firm	Audit firm changed	
KPMG	-	-	-	-	-	-	1	-	-
RSM	4	-	-	-	-	2	-	-	3
Audit-Professional	-	-	-	-	-	-	-	-	-
Baker Tilly	-	-	-	-	-	2	1	-	1
BDO	1	-	1	6	-	3	7	-	6
Grant Thornton	-	-	2	1	-	1	-	-	2
Deloitte	-	1	-	-	-	-	-	-	-
EY	-	-	-	-	-	-	-	-	-
Consaudi	-	-	1	-	-	-	-	-	-
Moore Abc	-	-	1	-	-	4	1	-	6



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Nexia TA	-	-	-	-	2	6	1	-	4
PKF	-	-	1	-	-	2	1	-	7
PwC	-	-	-	-	-	-	-	-	-
Total	5	1	6	7	2	20	12	-	29
as %	50%		50%	31%		69%	29%		71%

However usually there is familiarization threat existing in audit with the same client strengthened by the fact of not changing the engagement partner, in our opinion this trend might be also because the clients reporting status is improved from year to year with the same audit firm recommendations and findings.

Likewise, in yearly perspective we can trace the tendency of changing or not changing the auditors' opinions from unmodified (clean) to modified with the same clients compare to previous year reports.

Audit Firms	2017 financial year			2018 financial year			2019 financial year		
	Changed opinion to previous year from unmodified (clean) to modified by		Opinion has not been changed to previous year	Changed opinion to previous year from unmodified (clean) to modified by		Opinion has not been changed to previous year	Changed opinion to previous year from unmodified (clean) to modified by		Opinion has not been changed to previous year
	same Audit firm	Audit firm changed		same Audit firm	Audit firm changed		same Audit firm	Audit firm changed	
KPMG	-	-	4	1	-	15	2	-	11
RSM	1	-	1	2	-	2	1	-	1
Audit-Professional	-	-	2	-	-	3	-	-	1
Baker Tilly	-	-	-	-	-	1	-	-	-
BDO	-	-	8	2	1	9	3	2	7
Grant Thornton	-	-	-	-	-	-	-	-	-
Deloitte	-	-	3	-	-	5	-	-	3
EY	-	-	10	-	-	14	3	-	12
Consaudi	-	-	-	-	-	-	-	-	-
Moore Abc	-	-	2	4	-	-	-	-	2
Nexia TA	-	-	2	4	-	5	2	-	6



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PKF	-	-	3	8	-	7	-	-	5
PwC	-	-	4	-	-	5	-	-	7
Total	1	-	39	21	1	66	11	2	55
as %	2.50%		97.50%	25%		75%	19%		81%

The main reason for changing of unmodified (clean) opinion to another (modified) could be, that starting from the 2018 financial year there are fundamental changes in IFRS standards and companies faced difficulties in meeting new requirements.

Ranking of Audit Firms by audited PIEs

The table below shows the percentage of the income of PIEs out of the total audited income of PIEs. The same percentage is given out of PIEs total assets and employees. As we can see the leader is Ernst & Young which audited 39% of total PIEs income in 2018 and 37% in 2019 respectively. Following by PwC and KPMG.

Audit Firms	Income		Assets		Employees	
	2018	2019	2018	2019	2018	2019
EY	39%	37%	46%	47%	44%	41%
PwC	32%	29%	42%	37%	17%	16%
KPMG	9%	16%	5%	8%	11%	14%
Grant Thornton	6%	6%	1%	1%	10%	11%
BDO	5%	4%	1%	2%	6%	6%
Deloitte	3%	3%	2%	2%	4%	4%
Moore Abc	1%	3%	0%	2%	1%	4%
Nexia TA	2%	2%	0%	1%	2%	2%
RSM	1%	1%	0%	0%	1%	1%
PKF	1%	0%	1%	0%	1%	1%
Baker Tilly	1%	0%	0%	0%	3%	1%
Audit-Professional	0%	0%	0%	0%	0%	0%
Consaudi	0%	0%	0%	0%	0%	0%

Restrictions of Audit Fees

Audit vs Non-audit service fee

According to the European Union legislation, non-audit services provided by the statutory auditor of the PIE are subject to a cap 70 percent of the average of the fees paid in the last three consecutive financial years for the statutory audit of the audited entity and, where applicable, of its parent undertaking and controlled undertakings and of the consolidated financial statements of that group of undertakings.

Georgian legislation is not requiring the same for Georgian PIEs, but we think it should be the subject of the observation as it touches the audit firms which are conducting audit for PIEs. Since we have data for only two years 2018 and 2019, we can observe only this information. The table below shows that in 17 cases out of 100 (or 17%) in the financial year of 2018 the total fees for non-audit services was >70% than the fee earned from the statutory audits. The same trend maintained in 2019, 16 out of 91, which is 18%.

	2018	2019
>70%	17	16
Total	100	91
	17%	18%

General finding from this is that the state regulator SARAS shall pay more attention to possible infringement of the independence by the referred audit firms.

One PIEs fees vs total fees received

The EU Regulation requires that when the total fees received from a PIE in each of the last three consecutive financial years are more than 15% of the total fees received by the statutory auditor or the audit firm, in each of those financial years, such a statutory auditor or audit firm shall disclose that fact to the audit committee and discuss with the audit committee the threats to their independence and the safeguards applied to mitigate those threats.

Audit engagements, which are assurance engagements in which a professional accountant in public practice expresses a conclusion on financial statements. Such engagements comprise audit and review engagements to report on a complete set of financial statements and a single financial statement. Auditor independence meaning independence of both the firm engaged to perform external audits and the individual auditors who conduct the audits is a central facet of external auditing.

Law of Georgia on Accounting, Reporting and Audit does not require disclosing of these facts, but, due to requirements of EU as it touches the audit firms which are conducting audit for PIEs we observed the fees paid for the statutory auditor in 2018 and 2019.

Audit firms received more than 15% of the total fees from 25 PIEs out of 100 in 2018 (25%) and from 15 PIEs out of 91 in 2019 (16%).

	2018	2019
>15%	25	15
Total	100	91
	25%	16%

General finding from this is that the state regulator SARAS shall pay more attention to possible infringement of the independence by the referred audit firms.

COVID-19

We observed that auditors have not used the new coronavirus pandemic as a basis for modifying audit findings. Seven of them used a paragraph reflecting significant circumstances for significant audit matter.

Also, COVID-19 was mentioned in 88% audit reports in the aftermath of the reporting period.

We believe that impact of COVID-19 on auditors' opinion in the PIEs sector shall yet to come if this situation continues.

Concluding summary

PIEs faced some difficulties with the new requirements implementation. Our detailed analysis of 421 audit reports shows that the main concern of auditors, application of new accounting standards stays the same during 2017-2019 years.

Leader by number of submitted audit reports is BDO (79 reports), following by EY (56), KPMG (56) and PKF (54).

We found out that 63% of all submitted reports are Unmodified. The major unmodified reports were issued by EY (53) and KPMG (52). The leader in Conditional Opinion quantity is PKF (24 out of total 100).

The impact of COVID-19 is a key event that auditors need to consider when deciding on the audit matters for the current period. Some of them used a paragraph reflecting significant circumstances for significant audit matter.

We do hope, that in the future companies will gain more experience in new International Financial Reporting Standards and will get closer with EU requirements. And on the other hand, the auditor will determine the best way to communicate to users based on the specific circumstances of the entity and the environment that it operates in.