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FAR Masterclass Report - 9 December 2019

Masterclass by Marshall Geiger, Anna Gold and Philip Wallage on ‘Going Concern Opinions (GCOs) in Theory & Practice’

Marshall A. Geiger is professor at the University of Richmond, Anna Gold is professor at the Vrije Universiteit Amsterdam and the Norwegian School of Economics (NHH) and Philip Wallage is professor at the Vrije Universiteit Amsterdam and the Universiteit van Amsterdam. The research they present is based upon the FAR research project ‘A Synthesis of Research on Auditor Reporting on Going- Concern Uncertainty (Project 2017A01)’, which can be found on the FAR-website.

On 9 December 2019, Marshall Geiger, Anna Gold and Philip Wallage presented a masterclass on Going Concern Opinions (GCOs). In this report, a summary of the masterclass is presented. The main purpose of the session was to communicate the main results of their literature synthesis (see Part I below) and to extend and corroborate the findings of the focus group meeting that was part of the research project, by means of an in-depth discussion concerning eight broad GCO topics (see Part II below).

Part I: Main results from the literature synthesis

The literature review was organized along three broad categories: (1) determinants of GCOs; (2) accuracy of GCOs; and (3) consequences of GCOs.

(1) Determinants: client characteristics, auditor characteristics, auditor-client relationship, regulatory oversight

Client characteristics

Clients are more likely to get a GCO if they:

- Have a new CFO.
- Have a poor work place environment for employees.
- Fail to remediate internal control deficiencies.
- Have a CEO with friendship ties to audit committee members.
- Employ a business strategy of innovation & have a fluctuating product mix.
- Engage in controversial activities related to customers, employees, the environment or the community.
- Have financial statement filing delays.
- Are overly optimistic:
    - Have overly optimistic financial forecasts.
    - Have over-confident management.
    - Report financial results more aggressively/positively (i.e., less conservatively).

Auditor characteristics

Auditors are more likely to issue a GCO if they:

- Are in an office (US) that had fewer type I errors in the previous year (i.e. there was a GCO without subsequent failure).
- Are non-Big 4 auditors in a state (area) that issued a lot of GCOs in the prior year.

Furthermore, auditors tend to fall prey to the judgment bias of evidence averaging. Instead of summing all of the evidence, auditors tend to average the diagnosticity of all the available evidence at the end of a task. Thus, significant evidence against the going-concern assumption gets averaged with milder evidence resulting in a more moderate evaluation than evaluating the significant negative evidence alone.

Auditor-client relationship

Regarding auditor switching and "opinion shopping", the GCO literature shows that:

- GCO issuance increases likelihood of auditor dismissal and that dismissals following a GCO are more likely when management is more powerful (i.e., longer tenures) than the audit committee.
- GCO issuance increases the likelihood of auditor resignation.
- Clients successfully engage in opinion shopping to avoid a GCO and these switching clients exhibit higher ex-post type II errors and lower type I errors.

Furthermore, in the US, there are found more type II errors in the early years of the audit. In other countries the findings are mixed.

Regulatory Oversight

In the area of regulatory oversight, the GCO literature finds that:

- Annually inspected (those with more than 100 public clients) non-Big N firms issue more GCOs compared to tri-annually inspected audit firms (those with less than 100 public clients) after the start of PCAOB inspections.
- Foreign auditors subject to new PCAOB inspections have a significantly higher probability of issuing a GCO.
- Firms sanctioned by Chinese inspectors issue more GCOs after enforcement actions.
- Non-Big N audit offices that have greater awareness of SEC enforcement actions are more likely to issue first-time GCOs.

The overall conclusion appears to be that increased regulatory oversight leads to more GCOs.

(2) Accuracy of GCO's: type I & type II "errors" and auditor characteristics

A type I error indicates a GCO without subsequent failure. A type II error indicates a failure without previous GCO. Increasing GCO rates generally increases type I errors without significantly reducing type II errors.

It is interesting to note that Statistical Failure Prediction Models like Altman Z and models of bankruptcy prediction use public data and are better predictors of company failure than GCOs.

The accuracy of GCO's is also related to auditor characteristics. For example, there are audit partner effects: GCO decisions are more accurate if the partners have higher IQs, have more education and have more years of (industry) experience. There is mixed evidence on whether Big N firms are more accurate than non-Big N auditors.

(3) Consequences of GCO's: to the client company, to users and to the auditor

A first-time GCO increases the company's cost of equity capital by an average of 3.3 to 5.2 percent. Credit rating agencies typically downgrade the company's credit rating after a first-time GCO. There are negative share price consequences to equity owners, consistent with prior research. However, receiving a GCO increases a financially distressed company's probability of bankruptcy (only) by an average of 0.84 percent in the US, suggesting that, in general, auditors and firms do not need to be overly concerned with the prospect of a GCO sending a company into bankruptcy (known as the 'self-fulfilling prophecy hypothesis').

Nevertheless, there is a significant negative association between GCOs and subsequent auditor litigation, suggesting that auditors deter lawsuits by issuing GCOs. Experienced investors associate type II errors with lower audit quality, and type I errors with higher audit quality, indicating investors prefer conservative GCO reporting from auditors.

Part II: Group discussion of the major findings with the participants

As a final stage of the GCO synthesis project, the research team had previously organized a focus group discussion with partner-level experienced audit practitioners in the Netherlands. The overall goal of this portion of the masterclass was to gather additional feedback from practitioners regarding some of the key recent research findings, and to obtain additional insights about what currently happens in audit practice with respect to GCOs, including what are the significant questions and issues practitioners encounter during the GCO decision process. To gather this feedback, several questions were created by the presenters and distributed to small groups of participants for discussion and then reported back to the entire group.

One member of the earlier focus group meeting was Fred Versteeg who is PPD at KPMG. During the masterclass, he shared some of his observations from the meeting. He acknowledged the phenomenon of 'information averaging', which indicates that auditors tend to average information instead of accumulating and adding it together. Also, the focus group was not so worried about type I errors. Furthermore, auditors were not so afraid of the self-fulfilling prophecy idea. However, it is recognized that clients tend to switch audit firm after receiving a going concern opinion, but the group believed that this was driven by the difficult and tedious underlying process resulting in a GCO, and not the opinion itself. Accordingly, auditors need to be people managers, and good in human relationships. These are just a few examples which validate and further illustrate the results from the literature review.

As mentioned, a major purpose of the masterclass was to extend and corroborate the findings of the focus group meeting. This was done by discussing eight topics, which are summarized under the headings below.

Interaction between audit team and professional practice department or Going Concern expert panel

Questions asked were:

- Do audit firms have procedures in place to consult with Going Concern Opinion specialists or panels?
- Is the timing and extent of interaction appropriate?
- Are there possible improvements?

Key points from the discussion:

- Formally, firms require consultations in case of GCO issues. But sometimes, auditors are not eager to consult if they are uncertain regarding the Going Concern issues. So, they might not consult when they actually have to. Some participants mentioned that you have to consult when you are in doubt, if certain circumstances exist. A rule of thumb was formulated: if a Going Concern issue is disclosed in the notes, you have to consult.
- Some firms have specialists on the teams. Then, depending on the industry, for example retail, specialists are required to be on the team if certain conditions are met.
- The GCO evaluation is preferably already done in the planning phase, but certainly in as early a stage as possible. Sometimes it happens too late. For example, because partners think that they can solve the problems themselves. Team, client and PPD then become stressed. This creates a difficult situation.

- GCO decision-making can be improved by engaging people, by having the proper knowledge on board within the firm.
- Component auditors often have different views on GCO judgments. We might consider something a going concern issue and they may not, or the other way around. It is also a cultural interpretation.

Use and effectiveness of predictive (statistical) models (like Altman Z)

Recent research suggests that financial distress models such as Altman Z, or specifically developed logit models are sometimes better predictors of company failure than auditors' Going Concern Opinions.

Questions asked were:

- What are the experiences from practice?
- How could this change in the future?
- What consequences will that have?

Key points from the discussion:

The need for more robust GCO decision models was discussed. It was noted that PwC built a model, next to the Altman Z model, in which public information is integrated with audit-related information. They use machine learning to predict patterns that might result in going concern risks, based on an algorithm developed from thousands of companies. The model has an 87 percent classification reliability, which is better than Altman Z. In addition, PwC is building a model using natural language processing, which uses non-financial information.

Based on the better performing model, the question was raised whether this doesn't increase the self-fulfilling prophecy. The answer to this was: 'probably yes', but if the audit firms don't start developing this, someone else, for example Google, will.

Value of publicly known versus privately known information for Going Concern assessment

Auditors have access to publicly disclosed information about clients, as well as a considerable amount of private information. Research usually addresses publicly available information.

Questions asked were:

- What types of information are most important in making Going Concern decisions?
- What are the experiences with public versus private sources in making Going Concern decisions?
- How can public and private information be better integrated?

Key points from the discussion:

- Typically, in making GCO decisions, auditors look at information provided by the company. We should also use more information from public sources and how a company relates to other comparable companies.
- Engagement teams usually come up with market data, but management teams often think that they are special and different, and hence they find market data less or not applicable.
- The larger clients are typically more open to this kind of discussions, and they do have access to market data, which they also actually use. The smaller the company, the less this kind of information is being used.
- The challenge is to use both types of data – internal and public.

Self-fulfilling prophecy

One often discussed consequence for companies that receive a Going Concern Opinion is the self-fulfilling prophecy that the receipt of a GCO creates negative consequences which cause the already distressed company to fail.

Questions asked were:

- Is this something clients actually are concerned about?
- Do the participants believe this exists? And are Going Concern decisions driven by the risk of the self-fulfilling prophecy?

Key points from the discussion:

- Particularly for smaller companies, stakeholders are often already engaged, just in case of problems.
- It is hard to prove that a self-fulfilling prophecy exists. You cannot test, if a company went bankrupt, whether it was due to the GC opinion or to other factors.
- Studies don’t show that it is much of a valid argument. People always remember the bad outcomes, that is what sticks (i.e., a confirmation bias).
- In the UK, companies have to include a vulnerability statement. This emphasizes the responsibility of management in disclosing GCO-related issues.

Confusion between going concern topics included in Key Audit Matters and issuance of a Going Concern Opinion

In case of an uncertainty that is considered to be important, but not material, the ISAs allow auditors to emphasize this going concern uncertainty with a different wording in a voluntary explanatory paragraph to the auditor's opinion (ISA 706) or in a related Key Audit Matter (ISA 701). The financial statement users can then pursue further insights from reading the financial statements themselves.

Questions asked were:

- Does this lead to confusion?
- If so, how can this be prevented?

Key points from the discussion:

- Probably the users of the financial statements don't see the difference. But it doesn't really matter because in both cases there is discussion with the client about what will be discussed in the financial statements. That is the most important part.
- However, some participants state that ISA 706 in the context of a going concern is not helpful, it should be removed from the standards. A Key Audit Matter that appropriately articulates the reasons why the auditor spent so much time on it, is helpful to the readers.
- The man on the street is completely lost. But it is also confusing for the auditors themselves.
- Audit firms have different policies and practices regarding these standards.

Private versus public clients

Most research on Going Concern Opinion reporting tends to focus on publicly listed companies, given the public availability of the data.

Questions asked were:

- Is there any difference in the approach auditors use in Going Concern Opinion assessments between public and private client firms?
- Should there be differences?

Key points from the discussion:

- In general, it makes sense that standards are stricter for PIE companies/clients, because of the differing stakeholder groups, for example. However, not everybody agrees.
- Consequences of type II error will differ between private and public clients.

- In the Netherlands, the differences might not be very large. But outside of the Netherlands it could be the case, due to different regulatory regimes, regarding liability for example.
- In private companies, if there are problems, the most important stakeholders (e.g. banks) are already aware of problems that might exist.

Knowledge of Going Concern Opinions by others
Research suggests that audit practitioners seem to learn from their peers' GCO reporting frequency and their reporting errors.

Questions asked were:
- Are you aware of the GCO reporting process and decisions made by other practitioners in your firm and or office? And of other firm's GCO decisions?
- Do you think increase of (detailed) knowledge sharing about the GCO reporting process by peers would be beneficial?

Key points from the discussion:
- Within Dutch firms, these data are collected at the technical department, but it isn't available for other auditors within the firm. But, it might, for example, happen via the quality review partners.
- Often a GCO problem implicates a lot of effort from the audit partner and the engagement team. So, people within the office and even within the firm are often well aware of a GCO problem, but maybe not of the details.
- There was no real evidence of GCO information sharing between auditors of different firms.

The role of inspection
Recent research generally finds that the probability of firms' issuing a GCO significantly increases after the introduction of regular inspection, or the heightened threat of audit regular inspection.

Questions asked were:
- To what extent should regulatory oversight be perceived as a pressure to consider the issuance of a GCO?
- To what extent do you experience regulatory oversight as pressure to consider issuance of a GCO?

Key points from the discussion:

- Many participants indicated that they neither perceive nor experience any pressure from regulatory oversight to consider issuance of a GCO.
- Others recognize outside pressure from multiple angles.

Please share the findings!

The approach of this masterclass seamlessly fits into the main objectives of FAR: sharing and discussing research output with practitioners. The presenters therefore wholeheartedly stimulated the sharing of the findings by providing participants with the presentation slides to be shared within their audit firms, and particularly within the firm's technical departments.