FOUNDATION FOR AUDITING RESEARCH

Practice Note

Auditors' Going Concern Decisions: Insights from Practice

Grant Number: 2021B03

Presented to:

The Foundation for Auditing Research

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September 2023

The authors would like to thank all interviewees for their participation in this study. Furthermore, the authors thank the Foundation for Auditing Research (FAR) for their grant 2019B02. The views expressed in this document are those of the authors and not necessarily those of the FAR or any individual interviewee.

Auditors' Going Concern Decisions: Insights from Practice

Executive Summary

This practice note provides initial insights from an interview study that investigates audit professionals' decision-making processes regarding their clients' ability to continue as a going concern. We find that these decisions involve the activation of a range of different actors that the engagement leader needs to manage and coordinate. Specifically, auditors need to recognize going concern as a relevant issue (Phase 1). They then need to negotiate the involvement of their firm's national office and restructuring specialists (Phase 2). As they conduct the going concern assessment, they mobilize a range of internal and external actors to negotiate management disclosures and the inclusion (or not) of a going concern paragraph in their audit opinion (Phase 3).

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Introduction

The bankruptcies of Silicon Valley Bank and Signature Bank came 14 days and, respectively, 11 days after KPMG had signed off on its audits, raising questions about 'what KPMG knew about the two banks' financial situation and what it missed' (Weil and Eaglesham, 2023); all the while the audit firm itself made clear that it 'stood behind its audits' of the two banks (Reuters, 2023). As noted by former PCAOB chief auditor Douglas Carmichael, 'auditors are always under the microscope when the company fails shortly after the issuance of a clean opinion' (Weil and Eaglesham, 2023). These recent events confirm that decisions regarding going concern opinions (GCO) are among auditors' most important judgments, as they affect the auditee, financial statement users, financial markets, and auditors themselves. However, verifying management's assertion that an entity will continue as a going concern is also one of the most challenging tasks that auditors perform (ISA 570, IAASB, 2015).

As noted in the results of a previous FAR study (Geiger et al., 2021), there is ample research on externally observable factors determining auditors' GCO decisions and GCO outcomes for various parties in the audit supply chain. This prior research has been primarily archival in nature and has mostly included publicly available determinants of the GCOs. However, we argue that a GCO is the outcome of a complex decision-making process. Prior research provides relatively limited knowledge about key elements of the actual audit and decision process underlying GCO decisions.

This study is based on in-depth interviews with 39 audit professionals in the Netherlands and aims to investigate auditors' GCO decision-making process. Specifically, we focus on the initial evaluation of going concern-relevant evidence; auditors' decision to initiate and conduct firm-internal going concern consultations; the interaction and communication of auditors with firm experts and specialists, client management, and third parties; and auditors' judgment and

decision-making process amid prevailing uncertainty and pressures. While analysis of our interview data is ongoing, this practice note presents a preliminary overview of key insights from the interviews.

Research Methods

Table 1 presents an overview of our interviewees. We began our study in July 2022 with pilot interviews with members of the Dutch professional institute's workgroup on continuity, being audit firm representatives that concomitantly take leading roles in their respective firms' national offices and/or going concern consultation process. Based on these insights, we constructed our interview guide and contacted audit firms asking them to provide individuals within their firm that were involved with making recent GCO decisions. From October to December 2022, we engaged in the main part of our study by conducting in-depth interviews with 39 audit professionals (see Table 1). Interviews were typically done in person and held at university or audit firm premises, with three being held online for practical reasons.

Our semi-structured interview guide established key areas of interest but sought to give interviewees ample room to share their views and raise additional insights that had not been previously identified.[1]

Table 1: Overview of interviewees.

	National Office / GC Panel	Specialists	Auditors	Total
Big Four (from four firms)	7	5	17	29
Non-Big Four (from three firms)	5	-	5	10
Total	12	5	22	39

Average length of interviews: 65 minutes

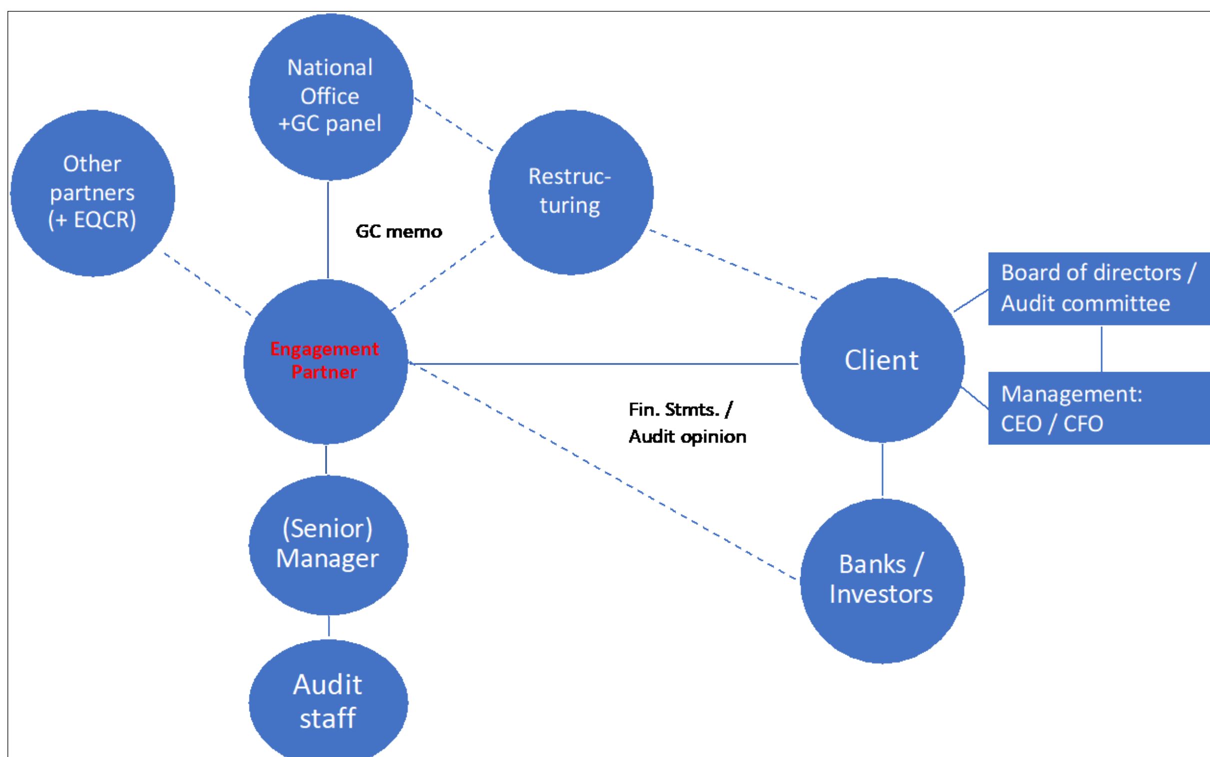
[1] Since GCO decisions are very sensitive, our interviews were covered both by a non-disclosure agreement of the sponsoring organization as well as a consent form that we shared with interviewees.

Note: A number of interviewees occupy several roles in their firms, such as being both lead partner on audit engagements and taking a role in national office. The above classification is based on the capacity in which we interviewed the respective person.

Preliminary Findings

This section outlines the going concern decision-making process that we have preliminarily identified in our data. It follows a set of three phases that entail the recognition of going concern as a significant audit issue (Phase 1), the outreach to others to set up a support network for the GC decision (Phase 2), as well as the evidence-gathering and assessment of the entity's ability to continue as a going concern (Phase 3). Notably, engagement leaders need to coordinate a range of relations in the process. Figure 1 displays the network that is activated in the course of a going concern decision.

Figure 1: Overview of network in the course of a going concern decision



Phase 1: Establishing going concern as a significant audit issue

Through interviewing experienced audit practitioners, we find that going concern decisions are both rare and idiosyncratic. That is, interviewees had been selected by their firms based on their recent experience of a GCO case, but it became clear that most of them did not have many

earlier cases that they could compare the specifics of their recent GCO experience to. Likewise, members of the going concern panels and national offices emphasized that in each case there were different issues at play, ranging from covenant breaches and uncertainty about renewing loans, to deteriorating business conditions, to the lockdowns of the covid pandemic, sanctions in the context of the war in Ukraine, or potential actions of significant investors.

While audit firms seek to highlight GCO-relevant issues to audit partners, based on news reports, industry developments, or financial statement data, it is up to the engagement leader to recognize and establish that an entity's ability to continue as a going concern is uncertain. This may be identified as early as during client acceptance or continuance where clients could, at the extreme, be rejected in case of significant doubt about their future. In most cases, however, it seems to be during the planning phase that engagement leaders are prompted by their firms' procedures to assess a number of potential red flags. Once identified by the auditor, a red flag for most firms automatically triggers a mandatory consult with national office, which then becomes involved to a varying extent in the eventual audit opinion decision (see below). Despite its rare occurrence, some interviewees indicated that, in fact, some level of experience is needed to fully recognize the events and conditions that might create uncertainty for the entity ('you only really see it once it happens at your client'). Others mentioned the role of a 'gut feeling' in identifying that something is not quite right, which for many comes from obtaining a detailed and intimate knowledge of the client entity and their business. It was also here that some interviewees acknowledged that not all auditors identify going concern risks as such, in which case these engagements are not consulted with national office.

The need to adequately problematize the audit as one where the going concern decision is a significant audit issues is hence a crucial first step that needs to be reflected both in the subsequent audit planning as well as in the range of interactions with other actors that are involved in the decision.

Phase 2: Negotiating involvement of national office and specialists

The subsequent outreach to other actors is meant to set up an action program to assist engagement leaders with the GCO decision, but it can also increase to the point that it 'kept me so busy at one point that I couldn't do my job anymore.' This outreach occurs in different steps, which initially involves contacting the national office. However, some audit firms seem to appreciate an informal interaction as part of 'a culture of deliberation,' before a formal consultation is submitted. At one end of the spectrum, it could be that this conversation determines that a 'red flag' is not an issue after all. In many cases, though, this informal outreach establishes the extent to which national office and specialists (e.g., restructuring) become involved in the audit. This could result in a 'co-reading' arrangement, where an engagement quality review partner or a specialist review the relevant audit documentation as the engagement team proceeds. In cases where going concern will indeed become a major component of the audit, this informal conversation may yield recommendations for specific audit procedures or establish that restructuring specialists will be involved in the engagement team itself, before the national office formally reviews the case in a consultation procedure.

Interviewees also emphasized the importance of 'taking the client along' in the process. This would begin at the moment that a going concern risk is identified, at which point it becomes clear that the audit will be highly demanding for the auditor and the client. This may entail additional analyses and documentation, but also the fact that many clients were said to require explanation of what a GCO in fact implies. Auditors also suggested that clients would occasionally invoke the 'self-fulfilling prophecy' argument, implying that a GCO would scare off business and capital providers and hence itself be the trigger for bankruptcy. While there is considerable academic research on this potential phenomenon (Carson et al., 2013; Geiger et al., 2021; Bosman et al., 2021), producing mixed results, the auditors themselves could not confirm such worries from their observations in practice. In addition, the auditors noted that

clients would need to be prepared for the additional audit fees that the going concern assessment would trigger, which could easily add up to 20% of regular audit fees.

Thus, this second phase sees the enactment of firm policies in the form of an initial outreach to the national office to set up the additional audit work, as well as the informing of the client about the significant risk identified. The latter interaction frequently involves an educating of the client about the meaning of a GCO and how it relates to their financial statements and disclosures, as well as an ensuring their collaboration in the assessment process.

Phase 3: Mobilizing internal and external actors in going concern assessment

In completing the going concern assessment, the engagement leader needs to coordinate the efforts of a range of parties to integrate different perspectives in the decision. In the audit team itself, this task primarily relates to making team members aware of the situation, not only because it may affect their client interactions, but also to see whether there are any 'derived risks,' such as the management of certain accruals to meet financial covenants. In general, however, it is mostly from the level of (senior) manager upwards that team members are involved in the GCO assessment, both to jointly manage the process and for ongoing discussions. Towards that end, auditors would also frequently reach out to individuals in their firms, such as engagement quality control reviewers or fellow partners to gather additional views on audit procedures to be performed as well as their insights on the decision-making process.

The assessment ultimately centers on whether the client has a 'fully-funded business plan,' meaning that there are no funding shortages in the twelve months after auditors' sign-off date and cash flow forecasts have sufficient buffer to leave no material uncertainty about the entity's continuance. Such audit work should in principle be based on client management's own position paper on going concern, although client expertise to develop such documents seems to vary widely. As such, the setting up of such position papers is one key issue that the engagement

leader needs to manage. Once this is available, the assessment is often conducted or reviewed by corporate finance/restructuring specialists, because of their extensive experience with assessing forward-looking financial information, cash flow forecasts, and the sensitivities surrounding such future scenarios. Some auditors note, however, that they also feel comfortable to make such assessments themselves, especially once they have developed some experience from prior going concern cases.

Next to the viability of future business, the need for refinancing may be a concern. Auditors vary in the ways they managed the relationship with banks (or investors). While some rely on the client to fully mediate this link, others indicated that they at times seek direct contact with these parties. This would primarily be the case in a 'chicken-and-egg situation,' when the bank would provide a waiver only if there were a clean audit opinion and the auditor requires a bank waiver to give a clean opinion. The wording of such waivers then also requires careful examination, because 'a bank can say a lot, but it doesn't count unless there is a signature,' meaning a formal commitment which ultimately would need to be provided by a bank's credit committee. Similarly, comfort letters were also seen as more intricate than auditors often realized. While such letters have in the past been readily accepted as confirmation of financial support from the parent company, they often lack legal substance and only cover the financing of ongoing business, rather than mitigating financial difficulties.

The engagement team is often expected to have gathered the relevant documents and reached a tentative conclusion before the engagement leader submits the case for mandatory consultation with the national office, which at the larger firms takes the form of a going concern panel. These panels embody the respective firms' technical expertise with regard to going concern opinions, assisting auditors with these rare and idiosyncratic situations. As such, when consulting with a panel for the first time, 'nine out of ten engagement teams are sent back with quite some homework.' Besides offering their knowhow, the panels operate at a distance to the

client and are hence seen as more independent and objective – which, however, comes at the expense of in-depth client knowledge. One key point for the consultation is whether management's discussion of going concern in its management report appropriately reflects the risks identified in the audit. The crafting and editing of this information may yield a lengthy back-and-forth between auditor and client management, both because the disclosures are required to be informative for financial statement users and because the GCO specifically refers to this section in the report.

In addition, typically the panels and audit partners jointly determine if there is significant doubt about the client's ability to continue as a going concern (ISA 570), which in most cases would trigger an emphasis of matter paragraph (ISA 706). While escalation procedures exist in the firms if differences between the panel and engagement leaders cannot be resolved, these were said to rarely be necessary, as panel and auditors mostly reach a consensus during their earlier discussions. However, we did find firm differences regarding views on including an emphasis of matter paragraph, where some firms felt it is 'better to be safe than sorry' and preferred to include one, while others do not want to issue such paragraphs unless they really needed to. Some interviewees also noted the possibility to include going concern as a Key Audit Matter in cases when the engagement team had conducted considerable audit work to ascertain there was no significant doubt about the entity's going concern. This route might be perceived by clients as less severe than an emphasis of matter paragraph in the audit opinion.

Conclusions and Relevance to Audit Practice

This practice note provides some initial insights into our interview study on how audit professionals assess an auditee's ability to continue as a going concern. We reveal that engagement leaders first need to recognize that going concern is a critical issue at a client, before they set up and mobilize a network of internal and external actors that are involved in

the going concern assessment. The engagement partner coordinates this network to negotiate both adequate management disclosures and the inclusion, or not, of an emphasis of matter paragraph in the audit opinion.

While at an early stage, our research seeks to contribute to our knowledge of how going concern decisions are made in audit practice. Much of the prior related literature is of an archival nature and has investigated a range of determinants and outcomes of going concern opinions (Geiger et al., 2021). We hence shed light on the 'black box' of going concern assessments, both to reveal the complex decision-making process by auditors as well as to inform future studies on further research opportunities.

In terms of practical relevance, our study offers a potential framework for best practices surrounding the GCO decision-making process, while identifying difficulties and challenges in the current GCO decision-making process. Even though this practice note provides only first insights of our study, we expect that the final results of our study may help audit firms to:

a) re-assess and enhance their GCO consultation processes;
b) shed light on the corporate reporting and assurance supply chain as it materializes in GCO decisions, and identify ways to enhance the audit link in this chain; and
c) identify prevailing impediments to auditors' professional judgment, and propose ways to resolve these.

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