

PRACTICE NOTE

Auditor Reporting for Going-Concern Uncertainty – Research Findings and implications for practitioner

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KEY TAKE-AWAYS

The auditor's decision regarding a going concern opinion (GCO) is among their most important judgments, as GCOs impact the client company, markets, financial statement users, and auditors themselves. Such a sensitive and complex judgement call requires expertise and experience. In the academic literature, GCO decisions are often seen as related to audit quality, and they are among the few observable outcomes of the audit that vary across engagements. In the last decades, academic researchers have spent considerable effort examining GCO decisions. We believe that audit practitioners can benefit from improved awareness of the insights that research has generated. In our complete report (Geiger, Gold, and Wallage, 2019), we review and synthesize 149 academic studies authored since 2013, the end of the previous synthesis by Carson et al (2013). In this practitioner note, we make a selection of what we deem the most...

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**Auditor Reporting for Going-Concern Uncertainty:
Research Findings and implications for practitioners**

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Executive summary: The auditor's decision regarding a going concern opinion (GCO) is among their most important judgments, as GCOs impact the client company, markets, financial statement users, and auditors themselves. Such a sensitive and complex judgement call requires expertise and experience. In the academic literature, GCO decisions are often seen as related to audit quality, and they are among the few observable outcomes of the audit that vary across engagements. In the last decades, academic researchers have spent considerable effort examining GCO decisions. We believe that audit practitioners can benefit from improved awareness of the insights that research has generated. In our complete report (Geiger, Gold, and Wallage, 2019), we review and synthesize 149 academic studies authored since 2013, the end of the previous synthesis by Carson et al (2013). In this practitioner note, we make a selection of what we deem the most interesting insights from our review, and discuss their implications for practice. We then report on our focus group engagement with audit practitioners where we obtained their perceptions regarding some the academic findings, the issues faced in making GCO decisions, as well as areas where additional research would be helpful.

Most notable findings from our literature review

Our literature review categorizes research into studies that examine the: (1) determinants of GCOs, (2) accuracy of GCO reporting decisions, and (3) consequences of GCOs. We discuss some practical implications throughout our summary and suggest that this overview be used to further stimulate discussion about (best) practice.

1. Determinants of GCOs

This category is further split into (a) client characteristics, (b) auditor characteristics, (c) auditor-client relationship characteristics, and (d) regulatory oversight. We briefly report the most insightful findings for each of these categories.

a) Client characteristics

The issuance of a GCO is primarily determined by characteristics of the audited client company. Among the most notable findings in the recent literature is that clients are more likely to receive a GCO if they:

- Have **financial statement filing delays** (Cao et al. 2018), suggesting that client delays in filing their financial statements is seen as a sign of risk or financial distress.
- Employ an **innovative business strategy** (e.g., often-fluctuating product mix, rapid and sporadic growth patterns) as opposed to firms that are cost-leaders with a narrow and constant mix of products, and cautious incremental growth patterns (Chen et al. 2017).
- Engage in **controversial activities** related to customers, employees, the environment or the community (Koh and Tong 2013).
- Are **overly optimistic**, for example have overly optimistic financial forecasts (Feng and Li 2014), have over-confident management (Kim 2017), and report financial results less conservatively (DeFond et al. 2016).
- Have a **new CFO** (Zaher 2015; Beams et al. 2016).
- Have a **poor work place environment for employees** (Huang et al. 2017).
- **Fail to remediate internal control deficiencies** (Hammersley et al. 2012).
- Have a **CEO with friendship ties to audit committee** members (Bruynseels and Cardinaels 2014).

Practical implications: These insights identify some of the key attributes that could be applied when determining continuity risks at a client company. As such they could be formalized as risk factors into audit programs.

b) Auditor characteristics

The issuance of a GCO is influenced by the characteristics of the auditors making the decision. We identify three groups of findings that we deem particularly interesting:

- World-wide, **Big 4 auditors** appear more likely to issue GCOs than non-Big 4 auditors (Habib 2013). However, follow-up research provides some mixed findings in this regard.
- A recent study (Ahn and Jensen 2018) finds that auditors use **information about their office's prior GCO 'error rates'** to improve audit quality and "calibrate" future GCO decisions.¹ Their results suggest auditors systematically adjust their GCO reporting

¹ Professional auditing standards have never required external auditors to predict the future viability of a financially or operationally distressed client. Nonetheless, academic research has referred to instances where an

thresholds after observing their office's type I and type II error rates. In terms of **practical implications**, sharing experiences regarding GCO's amongst colleagues may raise awareness and influence behavior. We suggest type I and type II errors should be shared on office and firm level discussions with the objective to learn.

- Lambert and Peytcheva (2017) find evidence that auditors are prone to the **fallacy of evidence averaging**. In other words, auditors tend to average the diagnosticity of all the available evidence jointly at the end of a task. Accordingly, when strong negative GCO evidence is averaged with milder negative evidence, or with positive evidence, it may lead to more positive overall GCO assessments than if the strong negative evidence was evaluated in isolation. This could be a problem if, for example, strong negative GCO evidence when evaluated by itself would cause the auditor to issue a GCO but when aggregated with other less negative information results in not rendering a GCO. In terms of **practical implications**, auditors should be cautious as going-concern related evidence is often evaluated at the end of the audit (all other evidence being available already).

c) Auditor-client relationship

An auditor's GCO decision is also influenced by the interaction between the auditor and their client. Again, we focus on the most interesting insights from our review:

- There is some evidence that **audit firm tenure** may adversely influence GCO decisions in the initial years of an engagement (Read and Yezegel 2016). Hence, from a **practical perspective**, auditors should exert particular care and attention for new audit clients.
- **GCO issuance increases the likelihood of auditor dismissal**; such dismissals following a GCO are greater when management is more powerful (i.e., has longer tenure) than the audit committee (Kim 2017). Anticipation of such practices may influence the auditor's objectivity in future reporting decisions and may stimulate "opinion shopping" on the side of the client. From a **practical perspective**, auditor awareness of such independence threats are important both for GCO decisions and in client acceptance decisions.
- Audit committees **appointing a former employer audit firm** are less likely to receive a GCO. However, larger and higher expertise audit committees mitigate this lower GCO propensity (Dhaliwal et al. 2015). Awareness of social ties and their potential adverse effects is important from a **practical perspective**.

d) Regulatory oversight

Recent research shows that inspections and enforcement actions have an effect on auditors' GCO reporting decisions.

- **Annually inspected** smaller (non-Big N) audit firms issue more GCOs compared to tri-annually inspected audit firms after the start of PCAOB inspections (Litt and Tayni 2017).
- Foreign auditors **subject to new PCAOB inspections** have a significantly higher probability of issuing a GCO (Lamoreaux 2016).

auditor issues a GCO and the company remains viable as a "type I" reporting error, and cases where a company is no longer viable, but the auditor did not previously issue a GCO as a "type II" reporting error. To be consistent with the research included in our review, we use the type I error and type II error terminology, even though these instances are not a reporting "error" on the part of auditors.

- Firms **sanctioned by Chinese inspectors** issue more GCOs after enforcement actions (Firth et al. 2014).
- Non-Big N audit offices that have **greater awareness of SEC enforcement actions** are more likely to issue first-time GCOs, while Big N auditors with greater awareness make fewer type II reporting errors (DeFond et al. 2018).

Summarizing, regulatory interventions appear to increase auditor's professional skepticism when it comes to GCO reporting. As less type II errors are a consequence of inspections and enforcement actions. From a **practical perspective**, auditors should be more skeptical in the case of material uncertainties about a client's going concern.

2. "Accuracy" of GCOs

The GCO is not intended to be an absolute prediction of company failure, yet one of the most pressing issues for all stakeholders is how a company can fail or go bankrupt shortly after receiving a clean, unmodified opinion (type II error). In other words, why can't auditors provide a more adequate early warning of impending business failure for companies going bankrupt? While to a lesser extent, the occurrence of type I reporting errors is also a reason for debate. Even though a GCO may have been warranted at the time of reporting, clients do not relish getting a GCO, particularly if they believe that they will remain viable (Geiger et al. 1998; Carcello and Neal 2003). Accordingly, the *accuracy* of GCOs has been a topic of considerable research over the years. The following are the, in our view, most interesting findings from recent research:

- **Increased GCO rates** generally *increase* type I errors but do not *reduce* type II errors (Blay et al. 2016; Carson et al. 2017; Chu et al. 2018). From a **practical perspective**, auditors should attempt to prevent type II errors, but also be aware that issuing too many GCOs leading to type I errors (auditors avoiding any risk) could negatively affect the value of a GCO in general.
- Statistical Failure Prediction Models (**SFPMs** - like Altman Z and models of bankruptcy prediction) use public data and appear to be **better predictors of company failure than GCOs** (Gerakos et al. 2016; Alareeni and Branson 2017). From a **practical perspective**, a well-developed SFPM could serve as an effective decision aid for auditors concerned with making more accurate going-concern judgements.
- Research examining partner characteristics finds that GCO decisions are more accurate when partners have **higher IQs** (Kallunki et al. 2019 – Sweden Male partners only), have more years of **experience, education**, and more **industry experience** (Che et al. 2018 - Norway). With respect to **practical implications**, these are interesting factors to consider when composing or evaluating audit teams that need to evaluate material uncertainty about the going concern a specific client.

3. Consequences of GCOs

Prior research has found adverse consequences to the current shareholders for GCOs in terms of negative market reaction, particularly for GCOs that were unanticipated by the market. However, researchers have broadened and deepened this main thread of inquiry in recent years. The following are, in our view, the most interesting research findings identified in the recent literature:

- 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, from a **practical perspective**, auditors and firms, generally, do not need to be overly

concerned with the prospect of a GCO sending a company into bankruptcy – i.e., the “self-fulfilling prophecy” hypothesis (Gerakos et al. 2016). Auditors should therefore be aware that client’s material uncertainty about the going concern could lead to bankruptcy and not the issuance of a GCO ‘as such’.

The following observations suggest that the auditor’s GCO is important as it has a substantial impact in a multitude of ways:

- A first-time GCO **increases** the company’s **cost of equity capital** by an average of 3.3 to 5.2 percent (Amin et al. 2014).
- Credit rating agencies typically **downgrade the company’s credit rating** after a first-time GCO (Feldman and Read 2013; Strickett and Hay 2015).
- Recent research documents **negative share price consequences** to equity owners (Czerney et al. 2019), consistent with prior research.
- Experienced investors associate **type II errors with lower audit quality**, and **type I errors with higher audit quality** (Christensen et al. 2016).
- There is a significant **negative association** between GCOs and **subsequent auditor litigation**, suggesting that auditors deter lawsuits by issuing GCOs (Kaplan and Williams 2013).

Some Observations of Practitioners from our “Focus Group” Discussion

As an important component of our project, in addition to synthesizing the literature we also engaged practitioners in order get their input. Accordingly, we organized a focus group discussion with partner-level experienced audit practitioners in the Netherlands. Our three overall goals for this interactive practitioner session were:

1. Gather feedback from practitioners on key recent research findings;
2. Gather practitioner responses to some specific questions to develop avenues for future research;
3. Gather insights about what currently happens in audit practice with respect to GCO and what issues practitioners believe are “burning questions”.

Again, we refer to our report for the complete results of the discussion and merely summarize here the most interesting insights and questions raised. Most of the observations are far from conclusive and almost all raise interesting questions to be examined in more detail by future practice and research.

- International GCO research typically makes a binary distinction between the presence or absence of a GCO. However, the ISAs allow auditors to emphasize “non-material” going concern uncertainties with a different wording in a voluntary explanatory paragraph to the auditor’s opinion (ISA 706) or in a related KAM (ISA 701). However, such disclosures are rare to date, and we observe that practitioners anticipate difficulties among financial statement users in adequately interpreting such disclosures. **This raises the question whether non-material going concern uncertainties should be included as KAMs in the auditor’s report, and how report users may interpret these varying disclosures.**
- One of our interests was determining whether audit firms have procedures in place to **consult with firm GCO specialists or panels** and how such procedures are organized. We learned that indeed firms typically work with in-house specialists/consultation

departments that are involved in response to certain triggers throughout the engagement.

- There is considerable variance in terms of the **timing of consultations** (early versus late) and concerns about timely involvement of in-house experts was discussed. Identifying the ideal timing for consultation is very difficult.
- **Younger partners** tend to consult earlier than older partners. Timing could also be driven by **partner tenure with a client**.
- The number of consultations appears to have increased as a result of **involving experts in the team**.
- Focus group participants recognize that **reliance on proprietary information** is much stronger than publicly available information, which might explain some research results.
- There was a general interest in **developing better statistical models** to be used as GCO decision aides.
- The importance of the **client's own GCO assessment** as required by ISA 570 was discussed as being critical to the audit process and to the evaluation of the adequacy of financial statement disclosure.

Further readings

See full report (Geiger et al. 2019).

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