Changes in auditing/accounting standards and auditor's going concern reporting

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ABSTRACT:

Many previous studies showed that more than 50% of bankrupt firms in the U.S. received a clean, unqualified audit opinion one year prior to their bankruptcy. In promulgating new auditing and accounting standards, the Auditing Standards Board (ASB) and Financial Accounting Standards Board (FASB), respectively, expected their respective standards to provide financial statement users with a timely signal of when firms are likely to cease operations. In conjunction with this expectation, an evaluation on auditors' performance was conducted by examining their rate of accuracy in issuing a going concern opinion to bankrupt firms within approximately 15 months before bankruptcy filing. In the present study, the accuracy rate for 4 different audit periods were investigated: SAS 59 (1989-1996), SOX (2003-2012), SAS 126 (2013-2016) and SAS 132/ASU 2014-2015 (2017-2019). Auditors (both Big 4 and non-Big 4) issued a going concern opinion to 49.1% (227/462) of soon-to-be bankrupt firms from 1989 to 2018. It is noteworthy that non-Big 4 auditors' performance (accuracy rate of 61.7% = 95/154) was much better than Big 4 audit firms (accuracy rate of 42.9% = 132/308). Also, non-Big 4 auditors outperformed Big-4 auditors during the SOX and SAS 132/ASU 2014-15 periods by marking the accuracy rate of 76.2% and 65.6%, respectively. But, Big-4 auditors' performance was disappointing. Their performance has steadily declined over time from 52.1% in the SAS 59 period (1989-1996) to only 26.5% in the SAS 132/ASU 2014-15 period (2017-2019).

Keywords: Audit accuracy, going concern, auditing standards, accounting standards, audit firms.

INTRODUCTION

In February 2017, the Auditing Standards Board (ASB) issued Statement on Auditing Standards (SAS) No. 132, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (SAS 132) to clarify the auditor's responsibility to address both substantial doubt and the use of the going concern basis of accounting. Specifically, SAS 132 – which superseded SAS 126 – required auditors to (1) assess the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements and (2) conclude whether substantial doubt exists about the entity's ability to continue as a going concern for a reasonable period of time, among other matters. This new auditing standard clarifies that the two requirements are auditors' separate determinations and conclusions based on audit evidence obtained. Also, the definition of a reasonable period of time has changed from a period of time not to exceed one year beyond the date of the financial statements being audited to within one year after the date the financial statements are issued (or available to be issued, when applicable).

The main objective in the development of SAS 132 was to address the accounting provisions of the Financial Accounting Standards Board (FASB) Accounting Standards Update (ASU) No. 2014-15, *Presentation of Financial Statements-Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern* (ASU 2014-15). ASU 2014-15 provides reporting guidance in generally accepted accounting principles (GAAP) about management's responsibility to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern. More specifically, ASU 2014-15 required management to perform assessments of an entity's ability to continue every reporting period, including interim periods, within one year of the date that the financial statements are issued or available to be issued. This is the first time that GAAP require management to explicitly take the initiative in identifying and assessing those adverse conditions or events that raise substantial doubt about an organization's ability to remain in business (Clikeman 2018). Several auditing standards required auditors to evaluate going concern before, but no such requirement existed for management to perform its own assessment even though the responsibility for the financial statements belongs to management. This new accounting standard was issued in August 2014 and became effective for annual periods ending after December 15, 2016 and for interim periods thereafter.

With the introduction of ASU 2014-15, both management and auditors must perform their own separate, independent going concern assessments of the same entity because it extends the responsibility for performing the going concern assessment to management. It is the belief of FASB that "requiring management to perform the assessment will enhance the timeliness, clarity and consistency of related disclosures and improve convergence with International Financial Reporting Standards (IFRS) which emphasize management's responsibility for performing the going-concern assessment" (Mosco and Crowley 2014). Auditors still play an important role in going concern disclosures under the new auditing standards, but ASU 2014-15 shifted the disclosure responsibility to management and this shift may affect auditors' expectations of management when auditors issue their audit opinion.

BACKGROUND

Since the issuance of SAS 34, *The Auditor's Consideration When a Question Arises About* *an Entity's Ability to Continue in Existence*, in 1981, auditors have been obligated to communicate their concerns about an entity's going concern status through appropriate modifications of the audit opinion (AICPA 1981). SAS 34 was the first auditing standard in the U.S. to address auditors' responsibility for issuing a going concern opinion. However, auditors' assessment of going concern was required only "when information comes to his attention that raises a question about an entity's ability to continue in existence." (SAS 34, para.1). Under SAS 34, it was usually assumed that an entity would continue as a going concern and substantial doubt alone did not always result in the issuance of a going concern qualified opinion. Auditors would, instead, leverage whatever substantial doubt that existed to "evaluate the recoverability and classification of recorded asset amounts and the amounts and classification of liabilities," and only "if uncertainty about assets and liabilities [remained]" would they then issue a going concern opinion (AICPA 1981).

In 1988, the ASB issued SAS 59, *The Auditor's Consideration of an Entity's Ability to Continue in Existence*, to bridge an 'expectation gap' between what the financial statement users believe auditors should be doing and what auditors were actually doing given the industry's understanding of auditors' roles (AICPA 1988). SAS 59 elevated the auditor's responsibility to report on an entity's "continued existence" (Ellingsen et al. 1989, Bell and Tabor 1991) by requiring the auditor to limit their analysis of an entity's going concern status to one post audit year (AICPA 1988). Unlike under SAS 34, substantial doubt under SAS 59, after the consideration of management plans to overcome any financial problems, is sufficient to require a going concern opinion (an explanatory paragraph) in the audit report even when asset recoverability and liability amounts and classification are not in question. Thus, SAS 59 expanded the auditors' traditional approach of discussing the going concern assumption only as it relates to the recoverability and classification of assets and liabilities (Ellingsen et al. 1989, Bell and Tabor 1991).

Congress passed the Sarbanes-Oxley Act (SOX) in July 2002 in response to a number of major corporate and accounting scandals including those affecting the Enron and Anderson failures, in late 2001 and early 2002, respectively. Audit firms claimed that they became much more conservative with respect to client retention and acceptance decisions because the risks associated with auditing significantly increased after the enactment of SOX (Rama and Read 2006). For example, SOX greatly altered the regulatory regime of auditing by shifting the oversight of audit firms from the private sector, AICPA, to the quasi-governmental Public Company Accounting Oversight Board (PCAOB). In 2008, the PCAOB issued Staff Audit Practice Alert No. 3 (PCAOB 2008) to suggest auditors to consider obtaining additional information that could result in client failures. Also, the insurance- and other liability-related costs increased significantly in the post-SOX period. For these reasons, it was expected that auditors changed their view of issuing audit opinions since the enactment of SOX (Ryu et al. 2009).

In July 2012, SAS 126, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, was issued to supersede SAS 59 and became effective for audits of financial statements for periods ending on or after December 15, 2012. And, while SAS 126 did not change or expand SAS 59 in any significant respect, it better aligned auditing standards with the ASB's Clarity Project and created a more easily understandable standard (AICPA 2012).

With the issuances of ASU 2014-15 in 2014 and SAS 132 in 2017, accounting and auditing standards became more congruent (Hasty 2017). While financial statements are the responsibility of a company's management, as written in the standard audit report, auditors were the only party performing the going concern assessment, prior to the issuance of ASU 2014-15. The going concern assessment had been in the purview of generally accepted auditing standards, but not GAAP (Davis 2012). ASU 2014-15 was intended to improve financial reporting by, among others, requiring an express statement and other disclosures that identify the conditions or events causing substantial doubt about an entity's going concern status assuming such doubt is not alleviated after a consideration of management plans. Also, SAS 132 expanded auditors' responsibilities for evaluating going concern by requiring auditors to identify and assess those adverse conditions or events that raise doubt about an organization's ability to meet its obligations as they become due (AICPA 2017). In addition, SAS 132 required auditors to take the extra step of inquiring of management about future plans, outside of the evaluation period, that might also impact the organization's ability to continue its operations (AICPA 2017). Auditors must highlight, through an emphasis-of-matter paragraph, the liquidity issues related to management disclosures even when substantial doubt has been alleviated by management's plans. The hope is that this increased responsibility on the part of management and auditors to assess the entity's going concern status will provide financial statement users with an early warning signal of when firms are likely to cease operations (Clikeman 2018).

Auditors have been criticized by many congressional hearings for not providing adequate timely warnings for soon-to-be bankrupt firms over the many years (U.S. House of Representatives 1985, 1990, 2002a, Geiger and Rama 2006). This is mainly due to failures of many publicly traded companies shortly after receiving a clean, unqualified opinion from their auditors. Many previous studies showed that auditors failed to issue a going concern opinion to organizations within a year of a bankruptcy filing more than 50 percent of the time (Ryu et al. 2009, Chen and Church 1992, Menon and Schwartz 1986, Altman 1982, Altman and McGough 1974).

Auditors are not responsible for predicting future events; so, the issuance of a going concern opinion is not a prediction of bankruptcy and an unqualified opinion should not be taken as proof of a business's continued existence. In reality, however, auditors may be criticized or sued if an unqualified opinion is issued when they should have issued a qualified opinion because many financial statement users expect a qualified opinion to be a useful indicator for a corporate failure (Hopwood et al. 1989). When an entity ceases to exist, it is common for lenders or shareholders who have sustained losses to blame the auditors for not being skeptical or diligent enough to ascertain that there was a substantial doubt about the entity's ability to survive as a going concern and for failing to disclose such doubts if the auditors harbored them (Eickemeyer 2016). At least one federal court has called the issuance of a going concern opinion the most conspicuous 'red flag' an auditor can waive (In re North American Acceptance Corp. Securities Cases 1981), while many other courts at the state and federal levels have recognized the auditor's legal liability to known users of financial statements for negligently conducted audits. Also, although firms may go bankrupt in less than a year after receiving a clean opinion due to unforeseeable events, financial statements users certainly perceive these situations as a reporting error (McKeown et. 1991, Chen and Church 1992, Geiger and Rama 2006). Conversely, issuing a going concern opinion is likely to impact client retention if the client emerges from financial distress without having to file for bankruptcy. Consequently, and as a practical matter, it may be difficult for auditors to ignore the business and market implications to issuing such an opinion. Obviously, the decision to issue a going concern opinion goes through a very complicated audit procedure and requires considerable auditors' professional judgement on many financial and non-financial factors including the likelihood of clients' failure. Thus, Nogler and

Jang (2012) argue that the decision to modify a client's audit report for going concern reasons is one of the most difficult decisions auditors must deal with.

In the present study, an evaluation on auditors' performance was conducted by examining how often auditors issued going concern opinions to organizations within approximately 15 months of a bankruptcy filing. The examination is associated with the Type II reporting error; failing to issue a going concern opinion to a firm that subsequently fails. The accuracy rate was investigated for the afore-mentioned four audit periods: SAS 59 (1989-1996), SOX (2003-2012), SAS 126 (2013-2016) and SAS 132 and ASU 2014-2015 (2017-2019). This paper reports how the changes in auditing/accounting standards and the enactment of the SOX influence auditors' propensity to issue a going concern opinion to their clients with financial distress.

SAMPLE SELECTION

A total of 462 firms that went bankrupt from 1990 to 2020 were found from the FactSet data base (https://www.factset.com). A term search, using "Bankruptcy Filing" and "Chapter 8/11", was used on the 8-K report filed with the Security and Exchange Commission (SEC). Then, we looked at these firms' audit opinion in their 10-K reports filed approximately 15 months before bankruptcy filing, as was done in Carcello et al. (1997). For the SAS 132 and ASU 2014-2015 period, firms that went bankrupt after the COVID-19 pandemic started (March 2020) were not included in the sample to avoid any effect of non-financial factors.

RESULTS

When comparing the frequency distribution of going concern opinions issued by both Big 4 (Deloitte Touche Tohmatsu, PricewaterhouseCoopers, Ernst & Young and KPMG) and Non-Big 4 firms, it is worth noting the consistency over time (see Table 1). Among 462 bankrupt firms, 308 firms (66.7%) were audited by Big 4 auditors and 154 firms (33.3%) were audited by non-Big 4. Also, 235 firms (50.9%) received an unqualified, clean opinion and 227 firms received a going concern opinion (accuracy rate of 49.1% = 227/462). Thus, auditors (Big 4 and non-Big 4) issued a going concern opinion to less than 50% of soon-to-be bankrupt firms during the 4 audit periods from 1989 to 2018. This is consistent with many previous studies published between 1970 and 2005, none of which identified the accuracy rate higher than 49.8% (Altman & McGouch, 1974; Altman, 1982; Menon and Schwartz, 1986; Chen and Church, 1992; Ryu et al., 2009, among others).

Notably, non-Big 4 auditors' performance (accuracy rate of 61.7% = 95/154) was much better than Big 4 audit firms (accuracy rate of 42.9% = 132/308) and the difference is highly significant in the Pearson's chi-square test for independence ($p = .0001$). This result is consistent with the empirical evidence provided by Kaplan and Williams (2012), DeFond et al. (2011), DeFond and Lennox (2011), Numan and Willekens (2011), Reichelt and Wang (2010), Ryu and Roh (2007), Chewning et al. (1989), Messier (1983), among others. These previous studies argued that Big 4 clients are financially healthier and therefore less likely to receive a going concern opinion than non-Big 4 clients. Non-Big 4 auditors, however, are more willing to modify their audit opinions because they have lower materiality thresholds on the issuance of qualified opinions than Big 4 auditors. As a matter of fact, the Big 4 auditor's performance has steadily declined over time, as shown on Figure 1, from 52.1% in the SAS 59 period (1989-1996) to only 26.5% in the

SAS 132/ASU 2014-15 period (2017-2019).

For the SAS 59 period (1989 – 1996), Big 4 auditors marked an accuracy rate of 52.1% (73/140) by issuing going concern opinions to soon-to-be bankrupt clients while non-Big 4 auditors marked a 50.0% (11/22) accuracy rate. This is the only audit period when the Big 4 auditor's accuracy rate is higher than that of non-Big 4, but the difference is statistically insignificant.

After SOX became effective in 2002, Non-big 4 auditors did an outstanding job in correctly issuing a going concern opinion to their soon-be-bankrupt clients. They issued a going concern modified report to 48 of 63 bankrupt firms marking an accuracy rate of 76.2%. Big 4 auditors' performance during the post-SOX period, however, was disappointing and even worse than their performance during the pre-SOX period with an accuracy rate of only 39.8% (37/93). This is a very surprising result considering the increased risks of lawsuits, government regulations, negative publicity in the media, etc. after the SOX. The statistical difference in the accuracy rate, 76.2% by non-Big 4 and 39.8% by Big 4 auditors, is highly significant ($\chi^2 = 20.0727$, $p < .0000$).

From 2014 to 2017 after SAS 126 became effective, we found a total of 78 bankrupt firms. The auditors (both Big 4 and non-Big 4) marked the accuracy rate of 35.9% (28/78) which was the lowest in the 4 audit periods. The significant decline in the audit performance is hard to explain because SAS 126 did not change or expand SAS 59 as previously mentioned. The difference in the accuracy between Big 4 and non-Big 4 is not statistically significant. Also, non-Big 4 auditors' performance was the worst in the 4 audit periods marking only a 40.5% (15/37) accuracy rate.

After ASU 2014-15 and SAS 132 became effective after December 15, 2016 and December 15, 2017, respectively, the overall performance by both Big-4 and non-Big 4 auditors, contrary to the expectation by ASB and FASB, was not much different from the previous audit periods. But, non-Big 4 auditors again outperformed Big 4 auditors and marked an accuracy rate of 65.6% (21/32). Big 4 auditors' accuracy rate was only 26.5% (9/34), worst in the 4 audit periods even after the two standards expanded both management's and auditors' responsibilities for their assessment of going concern. The difference in the accuracy rate between Big-4 and non-Big 4 auditors is highly significant at the .0001 level.

SUMMARY AND CONCLUSIONS

Many previous studies have investigated the relationship between audit firm size and the propensity to issue a going concern opinion to distressed clients, i. e., Type II reporting error. Since litigation and reputation losses increase with the size of audit firms, big audit firms are more likely to issue a going concern opinion more often than small audit firms (Berglund et al. 2018; Geiger and Rama 2006; Geiger et al. 2005; Lennox 1999; Raghunandan and Rama 1995), but the empirical evidence is rather mixed.

In this study, we evaluated auditors' audit performance in terms of their rate of accuracy with which auditors correctly issued going concern opinions to bankrupt firms within approximately 15 months prior to bankruptcy filing for the 4 different audit periods: SAS 59, SOX, SAS 126, and SAS 132/ASU 2014-2015. A total of 462 firms were found to go bankrupt from 1990 to March 2020. The overall accuracy rate (49.1% by both Big-4 and non-Big 4 auditors) is fairly consistent with prior research, but non-Big 4 auditors outperformed Big-4 auditors, 61.7% by non-Big 4 but only 42.9% by Big-4. It is notable that non-Big 4 auditors' accuracy rate has been higher than that of Big-4 after the most current auditing (SAS 132) and accounting (ASU 2014-15) standards on the going concern modifications became effective.

Auditors serve the accounting profession as an intermediary between the business enterprise and the users of financial statements. Arguably, nothing is more fundamental to the auditors' role than their evaluation of an entity's ability to continue in existence. However, the question remains as to whether auditors have assumed enough responsibility to meet public expectations for evaluating and communicating about the ability of an entity to continue as a going concern. Also, in the auditing profession, it has been long argued that there exists an expectation gap - a difference between what the users believe auditors are responsible for and what the auditors believe their responsibilities are. This gap seems to still exist even after SAS 132 and ASU 2014-15 became effective after December 15, 2016 and December 15, 2017, respectively, mainly due to the audit performance by Big-4 auditors.

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APPENDIX

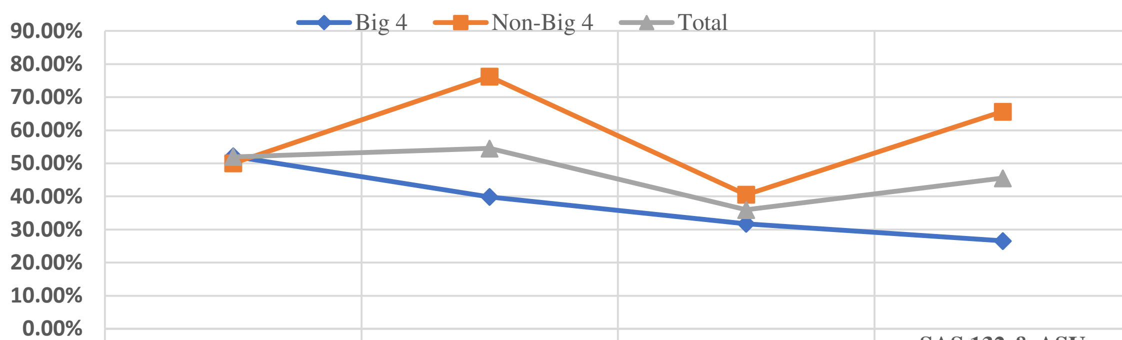
TABLE 1
Performance by Auditor

Audit Period (Year of Audit Opinion Issued)	Audit Opinion	Big 4	Non-Big 4	Total	Pearson's χ^2 Statistic (P-Value)
	UNQ*	67	11	78	

SAS 59 (1989 – 1996)	GCO*	73	11	84	$\chi^2 = 0.0350$ (.8517)
	Total	140	22	162	
	AR**	52.1% (73/140)	50.0% (11/22)	51.9% (84/162)	
SOX (2003 - 2012)	UNQ	56	15	71	$\chi^2 = 20.0727$ (< .0000)
	GCO	37	48	85	
	Total	93	63	156	
	AR	39.8% (37/93)	76.2% (48/63)	54.5% (85/156)	
SAS 126 (2013 – 2016)	UNQ	28	22	50	$\chi^2 = 0.6595$ (.4168)
	GCO	13	15	28	
	Total	41	37	78	
	AR	31.7% (13/41)	40.5% (15/37)	35.9% (28/78)	
SAS 132 & ASU 2014-15 (2017 – 2019)	UNQ	25	11	36	$\chi^2 = 10.1932$ (.0014)
	GCO	9	21	30	
	Total	34	32	66	
	AR	26.5% (9/34)	65.6% (21/32)	45.5% (30/66)	
Total	UNQ	176	59	235	$\chi^2 = 14.5671$ (.0001)
	GCO	132	95	227	
	Total	308	154	462	
	AR	42.9% (132/308)	61.7% (95/154)	49.1% (227/462)	

*UNQ: Unqualified, Clean Opinion, GCO: Going Concern Opinion,
**AR = Accuracy Rate = GCO/Total

FIGURE 1
TREND IN ACCURACY RATE



	SAS 59	SOX	SAS 126	SAS 132 & ASU 2014-15
Big 4	52.10%	39.80%	31.70%	26.50%
Non-Big 4	50.00%	76.20%	40.50%	65.60%
Total	51.90%	54.50%	35.90%	45.50%