# LOOKING INTO THE EXPECTATION GAP - WHAT ARE GOING-CONCERN ASSUMPTIONS REALLY ABOUT?

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**Abstract**

The question of whether or not a company will be able to continue to do business is at the core of every audit. Despite the importance of this part of the audit, little is known about what triggers an auditor to issue a qualified opinion based on going-concern uncertainties. Previous research has suggested that the auditor might act strategically, using, e.g., ambiguous wording to avoid a qualification and negative consequences for the client and still communicate his concerns. Yet these studies failed to explain in what instances auditors use such strategies. We use a sample of 90 companies that were delisted from the Johannesburg Stock Exchange or received a qualified opinion, and show that the issuance of a qualified opinion is not correlated with the company's financial situation at all. We therefore suggest that the auditor's own risk assessment— whether or not he might risk a lawsuit if a due going-concern assumption is not issued—might explain much more about his decision than do specifics about the client company.

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## Introduction

External auditors provide assurance services to company stockholders and society in general. One of the main pillars of assurance services is the assumption as to whether the company to be audited will continue with its business operations or not. The going-concern assumption is fundamental in the preparation of a company's financial statements as it determines the basis on which the value of the assets and liabilities of a company is stated in the financial statements.. If the going-concern assumption is in jeopardy, this could result in the impairment of the company's assets (in order to reflect forced sale values) and also an upward adjustment of liabilities due to penalties for early settlement and/or breach of loan terms or covenants. An understanding about a company's ability to remain a going concern affects almost all steps of the audit, starting with client acceptance, planning the engagement, the actual audit procedures and in assessing the audit risk.

Despite its major importance for the audit, the Standards on Auditing (ISA) provide little guidance on how to assess a going-concern assumption. In fact, some of the example conditions listed in ISA 570 may only be identified or become apparent when it's "too late" in the eyes of stakeholders such as investors, lenders and auditors themselves. The quest for more insight into the possible future sustainability and development of companies has been strongly enhanced by various players, investors and creditors to name but a few. Particularly after high profile corporate failures, the quest forthe reasonswhy the auditors did not warn the public about the firms' failures is on (Tucker, Matsumura, & Subramanyam, 2003). The confusion of the auditor's role with a corporate failure prediction function is most likely one of the most prominent areas of the expectation gap.

Since Altman's famous z-score model (Altman, 1968)scholars have made interesting and promising advancements towards the prediction of bankruptcy. With the rise of these models the potential benefit that they could yield for auditors have been widely discussed. Indeed, research has demonstrated that statistical bankruptcy prediction models outperform auditors' going-concern judgement decisions when discriminating between bankrupt and non-bankrupt companies (e.g. Levitan & Knoblett, 1985; Kuruppu, Laswad, & Oyelere, 2003; Grant, Wheeler, & Ciccotello, 1998). However, there is a difference between the use of a creditor-based failure prediction model and the going-concern assumption of an auditor. A company with an unqualified audit report could still "go under" and a company with a qualified audit report could still continue operating as a going concern. Despite a long list of literature proving that corporate failure prediction models can help auditors to assess a company's going-concern status, these models are not mentioned by behavioural standards. Also, the latest ISA clarity project failed to provide specific guidelines on how to assess a going-concern

assumption. Although there is a list of variables provided that gives the auditor some guidance on when to qualify, what finally triggers a qualification remains a mystery.

## Background to the research problem

Research to date is inconclusive as to whether the qualification of the auditor has an information value at all for stakeholders of the company for which the financial statements are presented. Some studies suggest that the issuance of a going-concern opinion hold some explanatory power about company's likelihood to fail (e.g.,; (Hopwood, McKeown, & Mutchler, 1989), 1994; (Kennedy & Shaw, 1991); (Chen & Church, 1992)). Other works, however, focus on the market's reaction to a qualified going-concern opinion as a proxy for its information value (e.g. Dopuch, Holthausen, & Leftwich, 1986; Fleak & Wilson, 1994) and fail to provide a consistent answer as to the information value.

So far, the decision-making process to issue a going-concern assumption has been seen as two-fold. Firstly, the auditor gathers evidence to decide if the company really deserves a going-concern assumption and, secondly, decides whether or not to include a qualification. An interesting approach would be to add a third stage to this decision making, namely, the auditor's own strategic considerations. Once the auditor tells his or her client that he has decided to include a qualification, the client will try to fence it off. The auditor is therefore caught between professional duties to modify the going-concern assumptions and following her client's demands not to do so in order to avoid negative consequences. Arnedo et al. (2008) focused in their analysis on the wording auditors used in their reports on Spanish companies and found that ambiguity in wording is well suited to confuse the reader and thereby serve both ends. Interestingly, their attempt to correlate this ambiguity to explicatory variables like industry sector or the auditor-client relationship did not yield any results. Even when they looked at the financial situation of the client, they could not establish a relationship between the extent of ambiguity of wording and the likelihood of failure. This is remarkable, as one would certainly assume that a weaker financial situation would trigger a more ambiguous choice of words.

After groundbreaking works like Power's "The Audit Society" (Power, 1997), the auditing function came more and more under scrutiny from a socio-economic point of view. Questions were raised as to whether auditing might have taken on a myth-like appearance, a function mainly serving the profession's own needs. We are very interested in gaining a deeper understanding of the auditing function and how it feeds back into larger societal functions. Although we are fully aware of the fact that simple mathematical regressions will never be able to fully explain such a multi-facetted connection, we want to add to the Arnedo et al. (2008) work by continuing where they stopped, namely how to explore the auditor's strategic behaviour.

## Hypothesis

The objective of this paper is to understand better what the going-concern assessment really is and on what it is based. As the assessment is a matter of professional judgement, it is not possible to observe the decision making process directly. The first assumption we want to test is if the going-concern assumption is based purely on considerations about a company's financial strength. In such a case, the decision-making process should take the same aspects of a company into consideration as any other corporate failure prediction. Therefore, we would expect to see a high correlation between corporate failure prediction models and the auditor's opinion making.

> *Hypothesis 1: the financial strength of a company and going concern related qualifying opinions are highly correlated*

The auditor's main purpose is not to predict corporate failure but rather to assess if the financial statements are giving a true and fair view of the company's financial situation. A qualified audit opinion based on going-concern considerations might trigger a chain of events which might push a company out of business (e.g. Moizer, 1995). Although Citron and Taffler (2001)proved that the threat of a self-fulfilling prophecy doesn't pass the empirical test, other research suggests that it is a real consideration for auditors (e.g. Mutchler, 1984; Sikka, 1992, 1997). Therefore, the auditor might adopt a very prudent stance and try to avoid triggering a self-fulfilling prophecy by only qualifying companies in a very weak financial situation. Also the ISAs are quite supportive for a prudent approach in this regard. If prudence are indeed applied, some correlation between financial strength and going concern related qualifying opinions would be expected, but not necessarily a strong correlation.

> *Hypothesis 2: the financial strength of a company and going concern related qualifying opinions are correlated*

A third possibility would be that auditors base their qualifications on completely different stimuli that have nothing in common with corporate failure prediction considerations. The auditor might be less concerned with the survival chances of a business than with her own risk-management considerations. If, for example, she did not qualify and the company were to fail, what would be the risk of her suffering financial losses in a subsequent litigation? In this

case, we would expect to see no correlation at all between the corporate failure prediction models and the qualified opinions of auditors.

*Hypothesis 3: the financial strength of a company and qualifying opinions show no correlation*

## Review of the literature

Up to now there have been a number of studies discussing the usefulness of corporate-failure models in assessing the going-concern status of a company (Kuruppu, Laswad, & Oyelere, 2003). The study by Stice (1991)looked at whether a company's financial condition, asset structure, and sales growth have an impact on the likelihood of a company issuing flawed financial statements. Stice (1991) used Altman's z-score to measure the financial conditions of the companies in the sample. The model proved effective in identifying high-risk audit engagements and auditors can therefore use this information as a basis for higher audit fees and audit hours that match up with the risk of litigation attributed to the client(Stice, 1991).

Other studies widened the mathematical-model approach and added other behavioural-orientated aspects. Hopwood et al.(1989) first use a log-linear approach to investigate the relationship between bankruptcy and audit report qualifications within the context of one univariate and two multivariate models. The second multivariate model (a ratios and audit opinion model) is based on audit opinion types and 6 ratios that were derived from Beaver (1966), Deakin (1972)and Libby (1975)studies.

In contrast to the Altman and McGough(1974) study, Hopwoodet al.(1989) considered consistency exceptions, the subject-to opinion issued for other than going-concern opinion reasons, and going-concern opinion qualifications. They argue that an audit-opinion-only multivariate model was the least-cost option in the last three years before a company goes bankrupt (Hopwood, McKeown & Mutchler, 1989).

Starting off by comparing the auditors' abilities to identify problems when using relevant cues to the accuracy of a mathematical model, Kida(1980)tested if ratios could provide auditors with useful information when making going-concern decisions. Auditors indeed were able to distinguish problem from non-problem firms, given only ratios, with an average accuracy rate of 83 percent compared to the 90-percent accuracy rate achieved by the discriminant model. Kida (1980) attributed the difference between auditor and model accuracy previously found by Altman and McGough (1974)to auditors' judgments of continuity qualifications, which is not the same as auditors' predictions of problem firms.

Anandarajan and Anandarajan (1999) applied the predictive power of two machine learning techniques (ArtificialNeural Networks (ANN), and Expert Systems (ES)) and Multiple Discriminant Analysis (MDA). Based on actual decisions of auditors, the ANN model achieved the highest predictive accuracy at 85.8% compared to the MDA and ES models, which achieved predictive accuracies of 74.1% and 69.1%, respectively. The results for the ANN model compared favourably to Altman and McGough's (1974) study, which was 82% accurate. Companies with non-going-concern problems were appropriately categorised at a rate of 90% for ANNs, 75% for ES and 81% for MDA, lower than Altman's original study, which achieved 97% accuracy for non-failed companies. Testing forms of going-concern uncertainty reports, the ANN model achieved a predictive accuracy of 80% for modified reports and 83.2 % for disclaimer reports, compared to 72.1% and 74.3% for MDA, and 66% and 60.3% for ES, respectively. Kuruppu et al. (2003) tested whether statistical corporate liquidation models are effective for assessing a company's going-concern status. Their corporate liquidation model outperformed Altman's bankruptcy prediction model in predicting company liquidations in their sample of New Zealand companies (Kuruppu, Laswad, & Oyelere, 2003).Other authors have stressed the usefulness of corporate failure prediction models for inexperienced auditors (Paquette & Laurence, 1996).

## Research methodology

We take our empirical data from the Johannesburg Stock Exchange. To get a better understanding of the qualifying assumptions, we comprise a sample made out of (a) failed companies, where the going-concern assumption proved not to hold and (b) all those companies which indeed have received a qualified or modified opinion. The time period we covered ranges from Jan 1st 2000 to Dec 31st 2009. The JSE's Equity Markets and Continuing Obligations Divisions provided a list of 61 delisted and liquidated companies and a list of 168 companies of financial statements with qualified or modified audit opinions for the period. For the purpose of our research, we eliminated all companies delisted due to mergers, takeovers or similar transactions involving financially sound companies that delisted voluntarily. The sample of failed companies comprises 36 companies. Subsequently, we eliminated a further five companies that acted purely as shell companies, leaving a final list (a) of 31 companies

The original list of 168 companies' financial statements with modified audit reports includes companies that appear on the list more than once due to their audit reports being modified more than once during the period and includes companies whose audit reports were qualified for reasons other than going-concern uncertainties. Two companies with modified audit opinions were excluded from the sample. One such company did not have any assets and the second was excluded from the sample because it operated in

hyper-inflationary environment and its financial statements were not prepared in compliance with international financial reporting standards. After clearing the list, the final list (b) comprised 63 companies with modified audit opinions. Each company was only included once in the final sample list (b) as only the "first-time" audit opinion qualifications were selected (Dopuch, Holthausen, & Leftwich, 1986).

In respect of list (a), we examined the last audited financial statements issued prior to the company being liquidated to determine both the legal status and the type of audit opinion. The period from last balance sheet date to liquidation date ranges from just under 10 months to just over 4 years and 8 months. All the modified audit opinions were either due to going-concern uncertainties only or going-concern uncertainties in combination with other issues. The legal status and the date of going into liquidation for each company were verified against the Cipro database.

As a proxy for financial strength of the companies we use Altman's z-score (1968)as there is a body of literature that backs its effectiveness and it has been tested in different geographical environments (Altman & McGough, 1974). The company financial data, including market capitalisations, for both the failed companies sample and the sample of companies with modified opinions was obtained from the McGregor BFA Research Domain. Once the financial data for the failed companies and companies with modified opinion was obtained, we calculated the variables (ratios) required for both the original Altman's z-score.

The original z-score used the following final discriminate function:

$$Z = 0.012X1 + 0.014X2 + 0.033X3 + 0.006X4 + 0.999X5$$

Where:

X1 = Working capital/Total assets

X2 = Retained Earnings/Total assets

X3 = Earnings before interest and taxes/Total assets

X4 = Market value equity/Book value of total debt

X5 = Sales/Total assets

Z = Overall Index

*Source*: (Altman, 1968).

The variables were calculated in line with Altman's z-score. The X3 variable calculated (Earnings before interest and tax/ Total assets for the original z-score and Operating income/ Total assets for the EM Score), was in certain instances not the same because of non operating income and or expenses being included in the "earnings before interest and tax" figure used for the original z-score.

## Results

At first, we tested the accuracy of the z-score and the EMS score to predict corporate failure in the (a) sample of 31 JSE listed companies that have either been liquidated/dissolved or are in the process of being liquidated/dissolved. Nine companies were liquidated within 12 months of the last financial statement, 14 companies within 24 months and six companies after 24 months. Two more are in the process of being liquidated. In the sample of companies we identified as failed; only 4 companies received a qualified opinion.

In the (b) sample, we looked at companies that had received a qualified opinion, a total of 63 companies. We examined each of the companies' financial statements to confirm that the auditor's report was modified due to either going-concern uncertainties or going-concern uncertainties and other reasons. All companies were checked against the Cipro database to confirm their current legal status and, where applicable, the date when the company went into liquidation. Of the 63 companies which received a qualified opinion, only 23, or 37%, have subsequently been liquidated—although often years later. Of these companies, 40 companies were still in business. Interestingly, only one company went out of business within 12 months after the qualified opinion on going-concern. Four more companies ceased their activities within 24 months. Twenty companies ceased their activities later (and sometimes much later) than 24 months after they received a qualified opinion. To test our hypotheses formulated earlier, we pooled both subgroups together. Our sample contained 90 companies with their audit opinion (four companies appeared in both samples), the z-score and the information as to whether the company is still in business or not. To understand if the audit opinion is correlated with the likelihood of financial failure, we tested if the groups of companies which received a qualified audit opinion and the groups of companies which received an unqualified opinion would show significant differences in their z-scores. At first, we tested both groups positively for normality. Then, we applied a t-test to see differences between both groups in the means of the z-scores. In addition to the z-score, we divided our sample depending on their z-score into financially stronger companies (top 33%), financially average (mid 33%) and financially weak (lower 33%) companies.

## Findings and Conclusions

**Table 1.**

**Auditor opinion * financial strength Crosstabulation**

Count

| | | finstr | | | |
|---|---|---|---|---|---|
| | | weak | average | strong | Total |
| Audop | Q | 19 | 23 | 21 | 63 |
| | U | 11 | 7 | 9 | 27 |
| Total | | 30 | 30 | 30 | 90 |

**Chi-Square Tests**

| | Value | df | Asymp. Sig. (2-sided) |
|---|---|---|---|
| Pearson Chi-Square | 1.270[a] | 2 | .530 |
| Likelihood Ratio | 1.278 | 2 | .528 |
| N of Valid Cases | 90 | | |

a. 0 cells (.0%) have expected count less than 5. The minimum expected count is 9.00.

**Directional Measures**

| | | | Value | Asymp. Std. Error[a] | Approx. T[b] | Approx. Sig. |
|---|---|---|---|---|---|---|
| Nominal by Nominal | Lambda | Symmetric | .046 | .073 | .619 | .536 |
| | | Audop Dependent | .000 | .000 | .[c] | .[c] |
| | | finstr Dependent | .067 | .104 | .619 | .536 |
| | Goodman and Kruskal tau | Audop Dependent | .014 | .025 | | .534[d] |
| | | finstr Dependent | .007 | .012 | | .534[d] |
| | Uncertainty Coefficient | Symmetric | .008 | .015 | .569 | .528[e] |
| | | Audop Dependent | .012 | .020 | .569 | .528[e] |
| | | finstr Dependent | .006 | .011 | .569 | .528[e] |

a. Not assuming the null hypothesis.
b. Using the asymptotic standard error assuming the null hypothesis.
c. Cannot be computed because the asymptotic standard error equals zero.
d. Based on chi-square approximation
e. Likelihood ratio chi-square probability.

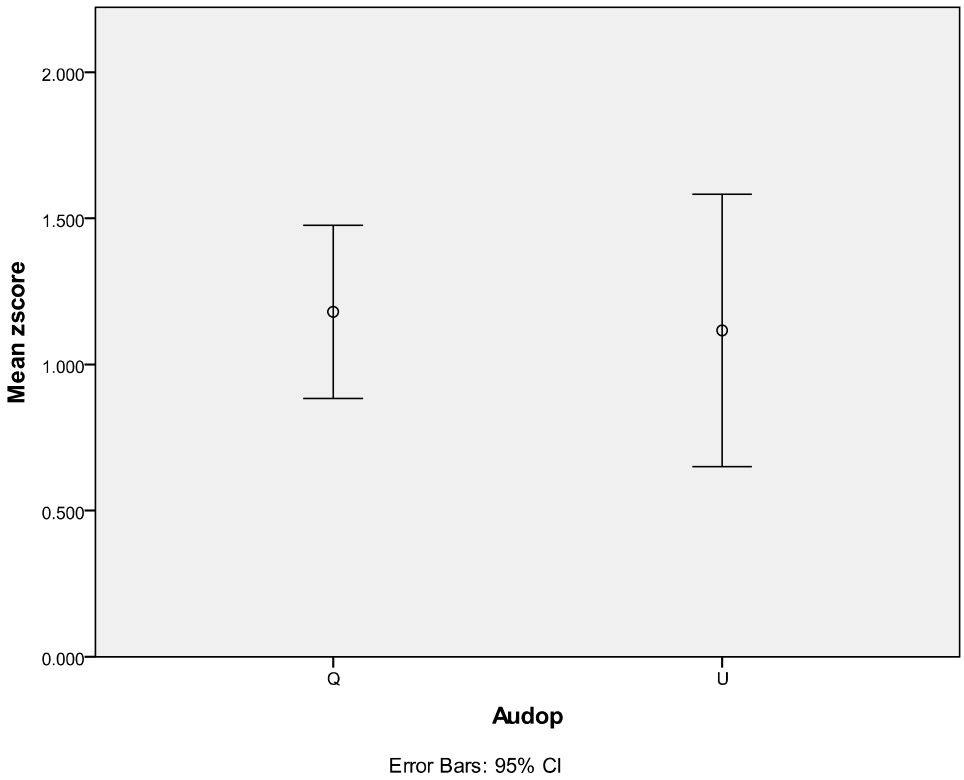
Interestingly, we see the qualified opinion equally distributed throughout all financial strength categories, similar to the unqualified opinion. From this cross table, it seems as if there is no connection of the audit opinion to the financial strength of a company. To test if this assumption holds, we performed an independent t-test to compare the means of the z-scores between both groups.

**Table 2.**

**Group Statistics**

| | Audop | N | Mean | Std. Deviation | Std. Error Mean |
|---|---|---|---|---|---|
| zscore | U | 27 | 1.11659 | 1.177460 | .226602 |
| | Q | 63 | 1.18019 | 1.177200 | .148313 |

**Table 3.**




The t-test performed on the z-score of companies showed no significant difference between companies that received a qualified opinion and such companies that received an unqualified opinion. In addition, the graphical presentation below underpins this finding.

Our analysis showed that both hypothesis 1 and 2 are rendered invalid, since the going-concern assumption is not associated with the financial strength of companies at all, leave alone a strong association. The statistical testing we applied did not support any significant difference between the z-scores of companies that received qualified opinions to those that received unqualified opinions. Neither could we prove that the auditors reacted prudently to avoid the risk of a self-fulfilling prophecy, which is in line with previous research that denied the existence of this phenomenon at all (Citron & Taffler, 2001).

If the decision on whether or not to qualify an audit opinion based on going-concern status is not influenced by the financial strength of a company, then what else drives this decision?

On one hand, auditors do have access to information that is exclusively accessible to insiders of the company. Managers might point out that the financial situation is not as dire due to expected positive future events. Yet, if these events are about to take place, it should improve the financial situation subsequently and the company should not fail at all. While this may explain why companies that received qualified reports never failed, it still does not explain why in our sample of 31 failed companies, only four companies received a qualified opinion. The same applies to the argument that auditors perform their work with a certain time delay between the end of the financial year and the actual audit and might have knowledge of additional events.

We suggest that there are other influential factors that are situated in the area of the auditing company itself. If we assume that the company under audit tries to avoid a qualified opinion at any cost, it will do everything possible to paint a positive picture of the company's financial outlook. The auditor will be tempted to believe and not to qualify—unless it would expose the auditing company to enhanced legal risks. Therefore, we suggest that the reason for qualifying a going-concern assumption is less likely to be found in the area of the audited company but more in the area of the auditing company.

As our findings suggest that there is no connection between the financial strength of a company and the audit opinion as to going concern, we doubt that there can ever be any true information value of a qualification of the audit opinion itself. If qualifications are, in fact, triggered by the auditor's own risk management considerations rather than financial considerations about the company under audit, this would also explain why previous findings about the information value or the market reaction of a qualification is so inconclusive.

Our findings themselves cannot dismiss the value of the auditing function nor do we attempt to do so. Yet, we would like to invite more research into how the going-concern opinion is explained. Which factors could the auditor use to estimate the risk of

litigation and a potential loss resulting from it? Which potential problems that might lead to a company failure will easily lead to a litigation claim against the auditor if it wasn't picked up by the audit and which are easy to defend? Once these factors are established, it would be interesting to see if they can explain whether or not a company receives a qualification.

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