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# Disclosure of going concern uncertainties in company accounts: the impact of a new reporting regime

David B. Citron and Richard J. Taffier

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# THE DISCLOSURE OF
# GOING CONCERN UNCERTAINTIES
# IN COMPANY ACCOUNTS:
# THE IMPACT OF A
# NEW REPORTING REGIME

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# Executive summary

The regulatory regime for going concern issues, introduced between 1993 and 1995, encompasses two auditing standards, SAS600 *Auditors' Reports on Financial Statements* and SAS130 *The Going Concern Basis in Financial Statements,* plus the Cadbury Committee's going concern disclosure requirement placed upon the directors of listed companies.

The motivation for this study is to evaluate the effectiveness of this auditing and governance regime in the sensitive arena of going concern uncertainty disclosures. In addition, while similar auditing standards were promulgated in the US in the late 1980s, it is only in the UK that the differential impacts of the audit report communication standard, SAS600, and the audit going concern standard, SAS130, can be evaluated separately due to the time interval between their introduction.

This research report meets the above objectives by testing whether the new regulations result in a significant increase in audit report going concern uncertainty disclosures among financially distressed companies. In addition we examine the level of compliance with the Cadbury Guidelines regarding directors' going concern disclosures.

Specifically, we test for increases in the rate of audit report going concern disclosures subsequent to the introduction of SAS600 and SAS130/Cadbury. To avoid potential confounding effects we control for other determinants of going concern qualifications/modifications such as company financial health, state of the economy and presence of a prior year qualification. Our population of firms comprises all UK listed and USM non-financial companies with year-ends falling between 31.12.91 and 31.12.96 at risk of financial distress.

We find a very significant increase in going concern disclosures subsequent to the introduction of the audit report communication standard, SAS600, but no incremental impact at all subsequent to the introduction of SAS130 or Cadbury. However, other impacts such as extension of the period covered by the forseeable future deserve further investigation. Moreover, in less than half of the 89 going concern modification cases issued subsequent to Cadbury does the directors' own disclosure adopt the 'pessimistic' style recommended in the Cadbury Guidelines rendering it consistent with the audit report.

Based on the results of our research we conclude that:

(i) in the case of going concern uncertainty reporting, where auditor-management conflict is inherent, facilitating auditor communication is particularly important in improving audit report bad news disclosures, and

(ii) as our findings relating to Cadbury demonstrate, a mere requirement for enhanced disclosures by management is insufficient unless accompanied by formal monitoring procedures.

# Chapter 1: The going concern auditing and reporting regime

## 1.1 Introduction

The current auditing and reporting regime for going concern issues is comprehensive. It encompasses two auditing standards. The first, SAS600 *Auditors' Reports on Financial Statements* (APB, 1993a), issued in May 1993, seeks to enhance the communication of audit findings to the users of a company's report and accounts. The focus of the second, SAS130 *The Going Concern Basis in Financial Statements* (APB, 1994b), published in November 1994, is on the improvement of audit procedures in the case of going concern uncertainty situations. Additionally, there is an associated requirement for company directors to report on their companies' going concern status, issued in the form of a guidance note (Cadbury Committee Working Group, 1994) concurrent with SAS130. This implements the earlier Cadbury Committee Code of Best Practice requirement (Cadbury Committee, 1992, para. 4.6).[1]

The development of this regime can be traced to a number of factors including perceived low rates of disclosure of doubts about the going concern presumption in auditors' reports. This was particularly so in the case of the low qualification rates of companies prior to failure, especially in the wake of major corporate collapses in the late 1980s and early 1990s. This issue became a key component of the 'expectations gap' debate and called into question the competence and independence of the professional auditor (Humphrey, Moizer and Turley, 1992).

Citron and Taffler (1992), for example, find that only 26% of listed industrial and distribution companies failing in the decade 1977-1986 were qualified on a going concern basis in their accounts prior to failure. They demonstrate that qualification was unlikely unless the probability of failure was very high, and the problems were already well known.

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[1] Interestingly, the importance of appropriate reporting of going concern uncertainties has again been emphasised in FRS18 *Accounting Policies* (ASB, 2000), the replacement for SSAP2, *Disclosure of Accounting Policies* (ASC, 1971). This accounting standard makes explicit directors' responsibilities for disclosure of material uncertainties regarding the firm's ability to continue as a going concern.

In their more recent study, conducted for the Association of Chartered Certified Accountants Research Committee, Citron and Taffler (ACCA, 1999) explore whether the publication of the Auditing Practices Committee's (APC) Audit Guideline *The Auditor's Considerations in Respect of Going Concern* (APC, 1985) strengthened auditor independence and contributed to an appropriate degree of signalling of imminent failure by auditors. However, their expectation that such formalisation of audit procedures would result in increased going concern qualification rates was not borne out by their empirical results. In particular, they find that only 15% of the listed and USM non-financial firm population failing between 1987 and 1994 had their last set of published accounts qualified on a going concern basis. In addition, they find that in only a handful of cases was information about the financial distress status of the qualified firms not already in the public domain. On this basis the authors suggest there were no 'costs' associated with giving a going concern qualification. At the very least there was no increase in qualification rates following publication of the APC's Audit Guideline.

Since public perception is that an audit report qualification for going concern issues is an indication of the financial distress status of the firm, such qualification rates clearly demonstrate that prior regimes were not effective.

In contrast, in the US, Raghunandan and Rama (1995) summarise six studies covering a similar audit environment to that pertaining in the UK under the 1985 APC Guideline, and find the proportion of bankruptcies with prior going concern reports averages 42%. Even this much higher percentage evokes concern among US commentators.[2]

The new UK auditing regime follows the introduction of the 'expectation gap' standards in the US in 1988 although, in a number of respects, the UK requirements are more far reaching. SAS No. 58 *Reports on Audited Financial Statements* (AICPA, 1988a), and SAS No. 59 *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, 1988b) constitute two of a series of more specific standards in the US designed to narrow the expectations and communications gaps between auditors and users of accounts (Roussey *et al*., 1988; Guy and Sullivan, 1988 and Ellingsen *et al*., 1989).[3] The UK's SAS600 was

[2] See, for example, the quotations in Raghunandan and Rama (1995) and Carcello *et al*. (1995).

[3] Ellingsen *et al*. (1989) in fact point out that '…when a business fails soon after its financial statements receive a clean opinion, some fingers invariably point to the auditors – even if the failure was due to sudden events after the audit.' They go on to ask: 'Have auditors assumed enough responsibility to meet public expectations for evaluating whether the companies they audit are able to stay in business?'.

foreshadowed by SAS No. 58 in the US. However, SAS130 in the UK requires both a more proactive approach to going-concern auditing and takes a longer view of the 'foreseeable future' than does SAS No. 59 in the US. In addition, the Cadbury Committee requirement for listed company directors to take responsibility for formal disclosure of the going concern status of their business is an original development.

## 1.2 Research objectives

Given these antecedents and the key issues of public concern leading to the promulgation of the new going concern regime, the purpose of this study is to explore empirically whether the objectives of this auditing regime have been met.

Specifically, the research sets out to test the impact of the new requirements by exploring whether there is a significant increase in going concern disclosure rates among financially distressed companies. We do this by comparing rates prior to the new regime and subsequent to its implementation over the six-year period terminating with December 1996 company year-ends. An integral part of this research is to explore the level of firm compliance with the Cadbury Guidelines.

This research study is important for a number of reasons:

1. It is crucial to be able to evaluate formally the effectiveness of new auditing standards in enhancing audit report disclosure and provide feedback to standard setters on this.
2. In particular, auditors' treatment of going concern uncertainties is a key issue of interest in its own right. This is both because of its importance to users of financial statements and because the going concern assumption is a fundamental basis on which financial statements are drawn up.
3. The going concern debate also impacts directly on publicly expressed concerns about auditor competence and independence and the ethical basis of the profession. Arguably, the going concern decision is the key area of management/auditor conflict.
4. The UK environment allows a much stronger test of the issues we explore than in the US where the parallel standards were issued, in effect, contemporaneously. Because SAS600 and SAS130 were published 18 months apart we are able to explore directly the comparable impact of the two standards with their different objectives. This issue is of particular

importance because it can help shed light on the relative effectiveness of audit disclosure compared with audit procedure standards.

5. The main distinguishing feature of the going concern reporting regime in the UK, vis-à-vis the US audit environment, is the important role of firm directors in the disclosure process. The publication of the Cadbury Committee guidance for directors on going concern represents a major innovation in corporate governance disclosures. Regulators need to know whether such requirements on directors are effective in practice.

## 1.3 The 'ancien régime'

The APC's 1985 Auditing Guideline, *The Auditor's Considerations in Respect of Going Concern* (APC, 1985), was the first attempt in the UK to address the auditor's responsibility in such situations. The only other guidance prior to this was in the accounting standard SSAP2 *Disclosure of Accounting Policies* (ASC, 1971).

The 1985 Guideline, which was promulgated after much contentious debate (Sikka, 1992), was characterised by:

1. A 'passive' audit approach, in common with the earlier US standard SAS No. 34 *The Auditor's Considerations When a Question Arises About an Entity's Continued Existence* (AICPA, 1981). The auditor was not enjoined to introduce any specific procedures for investigating the going concern status of the client '…since the matters identified … would normally be known to the auditor as a result of his other audit procedures' (APC, 1985, para. 15).[4]
2. The explicit mention for the first time of the period for the 'foreseeable future' which SSAP2 left undefined. The Guideline defines it as normally being '…a minimum of six months following the date of the audit report or one year after the balance sheet date, whichever period ends on the later date' (APC, 1985, para. 8).
3. In addition, the Guideline provides a list of prior indications of problems relating to the continuation of the business (paras. 9-11), which are largely

[4] The equivalent SAS No. 34 paragraph is even more explicit '…the auditor does not search for evidential matter relating to the entity's continued existence because, in the absence of information to the contrary, an entity's continuation is usually assumed in financial accounting' (AICPA, 1981, para.03).

self-evident. More importantly, for the auditor seeking to avoid the need to qualify, it also provides a list of mitigating factors (para. 12).

4. The Guideline also expands on the different categories of unqualified and qualified audit reports, in particular issues relating to emphasis of matter, the 'subject to' opinion and a disclaimer of opinion (paras. 24-30).

## 1.4 The new reporting regime

At the time of conducting our research the going concern reporting regime was made up of three component parts: a standard dealing with audit report content and format, SAS600; a standard governing the audit of going concern uncertainty situations, SAS130; and Cadbury Committee guidance on directors' going concern disclosures.[5] The time line of Table 1.1 highlights the events associated with implementation of those aspects of the new auditing regime investigated in this study.

[5] Recently, FRS18 *Accounting Policies* (ASB, 2000), replacing SSAP2 (ASC, 1971), and SAS610 (Revised) *Communication of Audit Matters to Those Charged with Governance* (APB, 2001) have been published. The new accounting standard *inter alia* increases directors' responsibilities for going concern reporting and the revised auditing standard requires auditors explicitly to discuss going concern uncertainties with company directors.

**Table 1.1 The audit regime relating to going concern – time line**

| May 1992: | December 1992: | May 1993: | 30 September 1993 | December 1993: | | 30 June 1995 |
|---|---|---|---|---|---|---|
| (i) SAS600 Exposure Draft<br>(ii) First SAS130 Exposure Draft<br>(iii) Cadbury *Draft Report* issued | Cadbury *Report* issued | SAS600 issued. Adoption encouraged | period-ends: SAS600 mandatory | Second SAS130 Exposure Draft | (i) November 1994 SAS 130 issued. Adoption encouraged<br>(ii) Cadbury *Guidance for Directors* issued | period-ends: SAS130 mandatory |

### *1.4.1 SAS600*

In 1991 the APB issued a consultative document *Proposals for an Expanded Auditor's Report – Consultative Paper* (APB, 1991) and this was followed by an Exposure Draft *Auditors' Report on Financial Statements – Exposure Draft* (APB, 1992). SAS600 was issued in May 1993 with immediate adoption encouraged, but required for all accounting periods ending 30 September 1993 onwards.

This revolutionary auditing standard was characterised by the following changes to the previous audit regime, in particular:

1. The respective responsibilities of directors and auditors for the financial statements are spelled out in the audit report.
2. In addition, perhaps as an attempt to reduce expectation gap concerns (Manson and Zaman, 1999), the audit report now indicates that the audit examinations are carried out on a test basis and only reasonable assurance of absence of material misstatement is sought.
3. Most importantly, for our purposes, the 'subject to' qualification disappears, being replaced by a fundamental uncertainty explanatory paragraph with the explicit proviso that this is not a qualification.[6] In particular, the original going concern *qualification* no longer exists, being replaced by a going concern *modification* which is more akin in style to the previous emphasis of matter which has been superseded.[7]
4. The audit report, which is now the best part of a page long, contrasts in length with the brief statement under the previous regime in the case of a clean audit report. As such, any fundamental uncertainty, such as a going concern modification paragraph, will not be so obviously apparent to the cursory reader.

A good example of a SAS600 going concern modified audit report, that for Rossmont Plc for the financial year ending 30th June 1996, is provided in Appendix I.

### *1.4.2 SAS130*

The specific auditing going concern standard was issued in November 1994, with implementation delayed until 30 June 1995 period ends, jointly with the Cadbury Guidance

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6 Qualifications now only relate to limitation of audit scope or inadequate disclosure.

7 This rarely used formulation was employed when the auditor wished to draw the reader's attention to an important matter but where a qualification was not warranted.

for directors on going concern issues. SAS130 was preceded by two exposure drafts, the first in May 1992, *Going Concern* (APB, 1992), and the second *The Going Concern Basis in Financial Statements* (APB, 1993) in December 1993.

SAS130 differs from the APC's 1985 Guideline in the following respects:

1. It requires a more proactive audit procedure. Specifically auditors should assess the adequacy of the means by which the firm's directors satisfy themselves that the going concern basis is appropriate.
2. As well as the actual standard being more than twice as long as the original APC guideline, SAS130 also includes over 20 pages of examples and a detailed flow chart.
3. In addition, SAS130 extends the foreseeable future in effect to one year from the date of approval of the financial statements.

SAS130 also effectively replaces SAS600's 'fundamental uncertainty' paragraph heading with the words 'going concern'.

### *1.4.3 Cadbury Guidance for Directors*

The 1992 Cadbury *Code of Best Practice, inter alia*, requires directors to report that their business is a going concern with supporting assumptions or qualifications as necessary (sections 4.5 and 4.6). However, a footnote indicates that firms would not be able to comply with these requirements until necessary guidance was issued. *Going Concern and Financial Reporting – Draft Guidance* was published by the Cadbury Committee in May 1993 and the guidance finally promulgated in November 1994, with immediate effect. The distinguishing characteristic of this guidance is to provide appropriate formulations of wording to cover situations both when the going concern presumption is appropriate (para. 49) and those when the going concern basis is used despite there being doubts on the firm's going concern status (para. 51). The bulk of the pronouncement consists of guidance for directors on those factors that should be taken into account in providing this disclosure. The appropriate location in the annual report and accounts is also specified.

To emphasise the relationship between SAS130 and the Cadbury Guidance the APB published a bulletin concurrently, *Disclosures Relating to Corporate Governance (revised)*

(APB, 1994b). This sets out the procedures required of auditors when reviewing the directors' disclosures. This bulletin, in particular, emphasises the importance of the Cadbury requirement on directors by stressing its codification in the London Stock Exchange continuing listing obligations (para. 4).

## 1.5 Overview

The principal objective of this study is to explore whether the new UK audit regime has had a measurable impact on auditor performance. In particular, we measure the outcome of the going concern evaluation process in terms of going concern modification rates among financially distressed companies and explore whether these differ under the new regime from the rates prevailing previously, controlling for other factors.

In addition, we examine the impact of the Cadbury Guideline on the disclosure behaviour of the directors of companies with going concern modifications. Are their going concern statements consistent with the financial status of their firm or are these at variance with the audit report?

We find that whereas SAS600, the audit report disclosure standard, had a measurable positive impact on going concern modified audit report rates, the combined SAS130/Cadbury Guidance package had none. In addition, we find that in many cases directors' going concern disclosures are at variance both with the financial state of their company and, more generally, with Cadbury Guidance requirements.

Our evidence, then, is consistent with the effectiveness of the audit report style (disclosure) standard SAS600, but not the going concern auditing standard SAS130, nor the Cadbury Code governance regime as regards directors' reporting on going concern status.

Prior research is reviewed in Chapter 2 and Chapter 3 addresses our hypotheses, methodology and data. The following chapter explores the financial characteristics of our firm population and reviews going concern disclosure rates as the audit regime changes over time. Chapter 5 evaluates the impact of SAS600 on auditor behaviour in this area and Chapter 6 provides a parallel analysis of the joint impact of SAS130/Cadbury Guidance. This is followed in Chapter 7 by a review of the reporting of going concern uncertainties by directors post-Cadbury. Chapter 8 concludes this report with a discussion of our results and suggested policy implications for standard setters and regulators.

# Chapter 2: Prior research

## 2.1 Introduction

This research explores the impact on auditor behaviour of the new audit and corporate governance regime in the going concern arena. The fundamental question is whether this has led to changed audit report outcomes and, implicitly, better information on firm risk factors for users of the annual report and accounts.

There is, however, a paucity of earlier studies focusing explicitly on the impact of changed audit regimes on auditor behaviour. In the US environment, the issuance of SAS No. 58, relating to audit report disclosures in general, was contemporaneous with SAS No. 59, relating to going concern audit procedures and associated disclosures. As such no conclusions can be drawn from the differential impact of these two dimensions on actual audit report outcomes. Similarly, the general literature relating to directors' voluntary disclosures does not address our focus on director behaviour following the implementation of the Cadbury guidelines, since, in the US, there is no such parallel requirement for directors to disclose the going concern status of their enterprise.

## 2.2 Attitudinal research into the new style audit reports

Geiger (1989) in the US and Manson and Zaman (1999) in the UK explore the formal responses by interested parties, predominantly audit firms and other professional bodies, respectively to the SAS No. 58 and SAS600 exposure drafts. Responses are generally favourable, including support for inclusion in the audit report of the statement that primary responsibility for preparing the accounting statements lies with management (Geiger) and also, in both countries, for the removal of the 'subject to' qualification.[8]

In Geiger's (1994) survey of bank loan officers his respondents were significantly more confident that old-style 'except for' qualified reports indicate absence of significant misrepresentation, in contrast with the new SAS No. 58 modified unqualified consistency report, in the case of an income-increasing accounting policy change. Carmichael and Pany

[8] This would, perhaps, be expected as such changes could reduce the conflict that auditors might experience in such situations as the going concern decision area; although it should be noted that neither study specifically addresses going concern issues.

(1993) cite user views that the ‘subject to’ opinion was valuable and its elimination could be viewed as an attempt by auditors to avoid their responsibilities to investors.

In addition, Manson and Zaman (1999) comment on responses that the old short form report gave a clearer ‘at a glance’ view of the auditor’s opinion in contrast to the new style modified report which was viewed as too verbose.[9]

The only other empirical work in the UK relating to SAS600 is that by Hatherley and colleagues (1991, 1992 and 1997). The authors adopt an ‘expectations gap’ approach, exploring whether the new style audit report brings auditors’ and users’ views closer together along differing dimensions using survey methodology. In their 1997 study of direct interest to us here (Innes *et al*., 1997), they find no change in the extent of the ‘gap’ regarding perceptions of company viability.

### 2.3 The new audit going concern standards

On the basis of discussions with practitioners, Carmichael and Pany (1993) find in the US that SAS No. 59 may well not have actually impacted on auditing procedures apart from increasing their formal documentation of going concern considerations. On the other hand, Grabowsky (1995), a UK Price Waterhouse auditing technical partner, expected the introduction of SAS130, coupled with the publication of the Cadbury Guidance, to bring renewed emphasis on going concern matters at board level and greater rigour in its consideration. In contrast to Carmichael and Pany (1993), then, the implication is that there would be an increased reporting of going concern issues in the audit report.

Much more relevant to our work are the four US empirical studies of Raghunandan and Rama (1995), Johnson and Khurana (1995) and Carcello, Hermanson and Fenwick-Huss (1995 and 1997). Raghunandan and Rama investigate the impact of SAS No. 59 on audit report modification rates for both non-failed financially distressed and failed companies. They find an increased rate of modification post- SAS No. 59 after controlling for financial performance ratios, size, audit report lag and lag till failure. Johnson and Khurana (1995)

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[9] We may speculate this is not necessarily a disadvantage for the auditor in a going concern situation, as management may be more prepared to accept a going concern modification (GCM) because it is, indeed, merely a ‘modification’ of the clean report. The old style going concern qualification (GCQ), in contrast, was radically different and prominent in the audit report. Essentially the issue is that if a GCM does not stand out then management may be less averse to its publication.

report similar results for a sample of bankrupt companies controlling for firm size and financial condition.

On the other hand, Carcello *et al*. (1995) investigate the impact of both SAS No. 34 (similar to our 1985 guideline) and SAS No. 59 on qualification/modification rates of failed companies audited by large audit firms. Degree of financial distress, client size, audit lag and debt default status are all controlled for. Whereas the authors find an increased modification rate post-SAS No. 34 (in contrast to Citron and Taffler, 1999, for the APC's 1985 guideline in the UK), they find no change (contrary to Raghunandan and Rama) post-SAS No. 59.

Carcello *et al*. (1997) attempt to reconcile the conflicting results of Raghunandan and Rama (1995) and their own 1995 study regarding SAS No. 59. In their analysis they ascribe Raghunandan and Rama's high post-SAS No. 59 GCM rates to their inclusion of part of the standard's transition period, which experienced particularly low going concern disclosure rates, as pre-SAS No. 59. Carcello *et al*. (1995 and 1997) overcome this problem by excluding these transition reports in their entirety, confirming the no effect outcome. However, Johnson and Khurana (1995) also exclude this transition period but still find SAS No. 59 to have an impact on modification rates, thus leaving the issue unresolved. Nonetheless, such a methodological approach results in omission of a potentially interesting period from analysis. We are able to consider this issue explicitly in our study using UK data.

Thus it would appear that in the US the jury is out on whether SAS No. 59 coupled with SAS No. 58, because these two cannot be separated, jointly lead to an increase in disclosure rates.

### 2.4 Variables explaining GCQs/GCMs

There is an extensive literature seeking to model empirically the audit report going concern disclosure decision. A recent comprehensive paper is Mutchler *et al*. (1997) who study failed companies. The authors find the following variables are significant in explaining audit report going concern disclosures: bankruptcy probability, lag from year end to audit date, lag from audit date to failure event, size (log sales), extreme negative bad news, debt payment default and covenant default. However, large auditor and debt default cured measures are not significant. Louwers (1998) investigates the incremental effect of variables measuring auditors' loss functions. He finds bankruptcy probability and change in audit report lag to be significant, but variables relating to litigation or loss of client revenues are not.

Krishnan and Krishnan (1996) study the qualification decision as a two-stage process. Variables indicating that a client deserves a GCM are receivables, liabilities, log (total assets), a net income dummy and a retail sector dummy. Variables indicative that an auditor will sign such an opinion, given that it is appropriate, are a composite measure of probability of litigation due to Stice (1991) and the magnitude of any prospective litigation payment as proxied by the extent of outsider ownership. Factors militating against the signing of such an opinion are the relative importance of the client to the auditor and client subsequent asset growth.

In their UK studies, Lennox (1999) finds leverage, return on capital and prior year GCQ to be significant and Citron and Taffler (1999), for their population of failed companies, find z-score and reported loss to be significant predictors. Carcello *et al*. (1995) find bankruptcy probability, client size, audit lag and default status significant. Raghunandan and Rama (1995) find a variety of financial measures – current ratio, recurring loss, cash flow and liabilities – to be significant in their non-failed companies model, and sales, reporting lag and bankruptcy lag in their failed companies model. Johnson and Khurana (1995) find a score computed from a multivariate failure prediction model to be the only significant control variable in their study.

The relevant UK guidelines include a number of measurable financial characteristics that auditors are required to explore in coming to their going concern qualification decision. Table 2.1 lists these.

**Table 2.1 UK guideline financial indicators of going concern problems**

| Indicators | 1985 Guideline | SAS130 | Cadbury Guidance |
|---|---|---|---|
| Recurring operating losses | * | | * |
| Working capital deficiencies/net current liabilities | * | * | |
| Over-gearing | * | | * |
| Deficiency of share capital and Reserves/excess of liabilities over assets | * | * | |
| Dividends in arrears | * | | * |
| Excessive stocks | * | | * |
| Overdue debtors | * | | * |
| Major post-balance sheet losses | | * | |

(Note: SAS130 and the Cadbury Guidance focus more on forecasts, budgets and general business factors rather than specific financial measures.)

## 2.5 Management propensity to disclose

In the context of the potential impact of the Cadbury Guidance on directors' going concern disclosures, which we address explicitly in Chapter 7, the literature suggests that managements disclose good news events far more frequently than bad news, e.g. Pava and Epstein (1993). Lev and Penman (1990) provide evidence that managers are more likely to release earnings forecasts when their firms are performing relatively well and the study of most relevance to us here, Frost (1997), shows that managements' disclosures in an audit qualification context are overly optimistic. Skinner (1994) also demonstrates that good news announcements have greater precision than bad news disclosures, although stock price response to the latter is greater.

The managerial literature exploring cases of firms approaching bankruptcy finds successful firm managements are distinguished by their focus on critical success factors in their output environment, whereas failing firm managements deny crises, look inwards and focus on the short term (D'Aveni and MacMillan, 1990). More generally, there is clear evidence of 'self-serving' managerial behaviour in annual report narratives in an attempt at 'impression management' to influence favourably the firm's various internal and external constituencies (e.g. Salancik and Meindl, 1984; Clapham and Schwenk, 1991 and Abrahamson and Park, 1994).

Aerts (1994) introduces a related concept, that of 'accounting bias' in management's narrative disclosures. Here the board again takes personal credit for successful performance, but now technical accounting terms are used to obscure the negative outcomes and to avoid managerial responsibility. Kelly-Newton (1980), in studying managers' responses to mandated replacement cost disclosures, similarly finds that managements seek to negate the content in the case of bad news through associated footnote criticisms of the value of the disclosure.

## 2.6 Summary

This chapter reviews the limited literature directly relevant to our empirical research. Much of the UK work is attitudinal and perceptual. In the US, problems associated with the contemporaneous promulgation of both the new audit report and going concern audit process standards prohibit differential analysis of the contribution of each to enhancing going concern audit report disclosures.

Our study is concerned both with exploring the impact of the new audit regime in the UK generally and also the differential impact of SAS600 and SAS130/Cadbury, which our audit regime allows us to do. In addition, we analyse directors' going concern disclosures following publication of the Cadbury Guidance and the extent to which these are consistent with auditor disclosures.

In Chapter 3 we draw on this literature to state our hypotheses and describe our empirical methodology and data.

# Chapter 3: Hypotheses, methodology and data

## 3.1 Introduction

The main thrust of this research is to explore the impact of a new going concern disclosure regime on auditors' and directors' disclosure activity. This chapter describes how we set about investigating these issues, the data we use and our prior expectations which we test expressed in terms of formal hypotheses.

## 3.2 Hypotheses

### *3.2.1 Impact of the new audit report style standard SAS600*

We highlighted the differences between the requirements of SAS600 and the previous audit report style in Chapter 1. *A priori,* we expect an increased disclosure rate of going concern uncertainties in firm audit reports following the promulgation of SAS600.

We expect that auditors would be more willing to provide a GCM than they would a GCQ *inter alia* because under SAS600 the audit report is explicitly not qualified. We forecast such absence of qualification will reduce the potential for auditor/director conflict and so ameliorate the 'costs' to the auditor of providing a GCM.

This expectation is further strengthened by the new requirement of SAS600 that the audit report includes a clear statement of directors' responsibilities for the preparation of the accounts. Although the directors' legal responsibilities do not change, we may expect the impact of such a statement would be to reduce auditor/director conflict when it comes to the disclosure of bad news.

In addition, given the expansive nature of the new audit report, we speculate that any GCM may be perceived by management as relatively inconspicuous and thus lead to reduced resistance to its presence. This contrasts with the obvious statement of going concern uncertainties conveyed by a going concern qualification in the previous short form audit report.

On the other hand, it may be argued that auditors will be less willing to provide a GCM because of the SAS600 requirement to head the relevant paragraph 'fundamental uncertainty’. Such increased prominence could be viewed as increasing the cost to the auditors of providing a GCM.

Nonetheless, overall we hypothesise that the arguments promoting increased going concern uncertainty disclosure following SAS600 outweigh the potential adverse impact of the paragraph heading. Null hypothesis $H_{01}$ is thus formulated:

$H_{01}$ *There is no increased rate of audit report going concern disclosure post-SAS600 compared with the pre-SAS600 period.*

### *3.2.2 Impact of SAS130/Cadbury guidance*

Since SAS130 was issued contemporaneously with the Cadbury Guideline it is difficult to separate out the impact of the two requirements. Considering first SAS130, *a priori* we would expect its promulgation to lead to a further increase in the GCM rate as, due to its more proactive audit procedures, auditors will be more likely to identify going concern problems than previously.

In addition, SAS130 effectively extends the period of the ‘foreseeable future’ to ‘one year from date of audit report’, increasing the likelihood of the auditor identifying going concern problems by virtue of the need to look further ahead.

Again, because of SAS130’s requirement for the auditor to consider going concern issues explicitly during the audit, there should be reduced auditor/director conflict when it comes to the disclosure decision. This is because the auditor now has increased authority derived from the auditing standard, leading to a higher rate of GCMs.

These expectations are reinforced by the concurrent issuance of the Cadbury Guidelines, which should have reduced the cost to the auditor of providing a GCM since the onus is now placed on directors to report on the firm’s going concern uncertainties themselves.

Thus we would expect a further increase in GCM rates post-SAS130/Cadbury and establish null hypothesis $H_{02}$:

$H_{02}$ *SAS130/Cadbury leads to no increase in audit report going concern disclosure rates.*

### *3.2.3 Directors' disclosures of going concern status*

As indicated above, it is difficult to separate out the impact of the new proactive audit regime and the effect of the requirement on directors to report on their company's going concern status. However, the extent to which directors follow mandated disclosure requirements within the context of the corporate governance debate is of significance to public policy makers. In addition, as we have argued, director compliance should have a positive impact on auditor going concern disclosure patterns.

To this end, we explore directors' disclosures under the Cadbury Guideline for our population of companies receiving GCMs. In particular, we investigate the extent to which directors report in accordance with the Guideline and whether their going concern disclosures are informationally relevant. This is measured in terms of consistency with the underlying financial position of their business, with the modified audit report itself and relevant footnotes to the accounts.

For companies with GCMs we expect the incremental cost implications for directors of making such disclosures to be minimal. This is because of the much more detailed negative information already conveyed via footnote disclosure and in the audit report. As such, we would expect the associated directors' going concern disclosures to be consistent with the relevant footnotes and audit report as well as the underlying financial status of the firm. Consequently we establish null hypothesis $H_{03}$:

> $H_{03}$ *Directors of companies with GCMs report in accordance with the Cadbury going concern disclosure requirements.*

## 3.3 Methodology

The main empirical analysis of the impact of SAS600 and SAS130/Cadbury on going concern disclosure rates revolves around a series of logistic regression models in which the key independent variables of interest are binary, representing the dates on which the relevant regulatory requirements come into effect. We control explicitly for firm-specific factors that might distort measurement of the impact of the new auditing standards and for changes in the economy. This is because qualification rates are likely to be partly determined by the state of the economy and its impact on the financial profile and future performance of the business.

Since only financially distressed companies are potential candidates for receipt of going concern uncertainty audit reports, as with Raghunandan and Rama (1995) we test for changes in audit report going concern disclosure rates within the population of financially distressed firms. This does not mean that the audit reports of these firms should contain going concern uncertainty paragraphs but only that such disclosures are very unlikely to occur outside this population.

We also explicitly work with a wider population than just failed firms because SAS130 itself does not require auditors to predict failure but 'to help ensure that doubts about the going concern presumption are detected and adequately disclosed in financial statements and auditors' reports'. (APB, 1992, Preface, para. 2.) In addition, there are many alternative resolutions of financial distress other than administration, receivership or liquidation.[10]

### *3.3.1 Logistic regression models*

1. To test the significance of SAS600 on audit qualification behaviour we run a set of logistic regressions across different time periods of the following form:

$$QUAL = f(SAS600, Z, NETWORTH, NETWCAP, GEAR, DIV, PBIT, ASSETLOG, AUDITLAG, QUAL_{t-1}, BIG6, GDPFCAST, INDUSTRY, MODEL). \quad (1)$$

   *QUAL* is a binary variable indicating whether or not the audit report is qualified or modified for going-concern reasons, represented by a GCQ or emphasis of matter (EOM)[11] prior to SAS600, or a GCM subsequently, and *SAS600* is a binary variable representing whether the audit report follows a pre- or post-SAS600 style. The other independent variables are control variables summarised in Table 3.1 with their predicted signs and with rationale discussed in the next subsection.

[10] For example, Citron and Taffler (1999, Table 12) show that 25% of companies with going concern qualified audit reports in their sample actually failed within the next year, whereas another 55% manifested such proxies for the failure event as financial reconstruction, major disposals or acquisition.

[11] The very small number of emphasis of matter cases in our sample precludes any separate treatment; as such we group these together with GCQ cases for analysis purposes.

**Table 3.1 Variables in the going concern disclosure logistic regression models**

| Variable | Meaning | Hypothesised sign |
|---|---|---|
| *QUAL* (*dependent variable*) | = 1 if GCQ, EOM or GCM (going-concern qualification, emphasis of matter, or going-concern modification),<br>= 0 if none of these | |
| *SAS600* | = 1 if *SAS 600*-style audit report,<br>= 0 if pre-*SAS 600*-style audit report | + |
| *SAS130* | = 1 if post-*SAS 130* audit,<br>= 0 if pre-*SAS 130* audit | + |
| *CADB* | = 1 if post-publication of Cadbury Committee *Guidance for Directors*,<br>= 0 otherwise | + |
| *Z* | = risk of failure as measured by a statistical model using a combination of financial ratios as independent variables | - |
| *NETWORTH* | = 1 if net worth positive,<br>= 0 if net worth negative | - |
| *NETWCAP* | = 1 if net working capital positive,<br>= 0 if net working capital negative | - |
| *GEAR* | = total liabilities/total assets | + |
| *DIV* | = 1 if dividend paid and not less than prior year,<br>= 0 if dividend either zero or cut | - |
| *PBIT* | = 1 if profit after exceptionals,<br>= 0 if loss after exceptionals | - |
| *ASSETLOG* | = natural log of total assets | ? |
| *AUDITLAG* | = number of days between period end and date of audit report | + |
| $QUAL_{t-1}$ | = 1 if no GCQ, EOM or GCM in prior year audit report,<br>= 0 if GCQ, EOM or GCM in prior year audit report | - |
| *BIG6* | = 1 if auditor not Big 6,<br>= 0 if auditor Big 6 | ? |
| *GDPFCAST* | = UK Treasury's GDP forecast for half-year within which audit report signed | - |
| *CONSUMER* | = 1 if not a consumer goods company,<br>= 0 if a consumer goods company | ? |
| *PROPERTY* | = 1 if not a property company,<br>= 0 if a property company | ? |
| *RESOURCES* | = 1 if not a resources company,<br>= 0 if a resources company | ? |
| *SERVICE* | = 1 if not a service company,<br>= 0 if a service company | ? |
| *UTILITY* | = 1 if not a utility company,<br>= 0 if a utility company | ? |
| *MODELA* | = 1 if *z*-score retail sector model not used,<br>= 0 if *z*-score retail sector model used | ? |
| *MODELB* | = 1 if *z*-score service sector model not used,<br>= 0 if *z*-score service sector model used | ? |

2. To test for the incremental explanatory power of SAS130/Cadbury we run a separate set of logistic regressions for different time periods with the following formulation:

*QUAL = f (SAS600, SAS130CAD, {control variables}).*
(2)

*SAS130*CAD is a binary variable indicating whether the audit report is before or after introduction of SAS130/Cadbury and the control variables are the same as in Table 3.1.

Nine different regression models are run. Four test for the impact of SAS600 on qualification/modification rates. Different data sets are used depending on the treatment of (a) the transition period associated with the auditing standard's implementation and (b) the inclusion/exclusion of cases affected by the subsequent introduction of SAS130. The results of these logit models are described in Chapter 5.

The other five logistic regressions relate to an analysis of the incremental impact of SAS130/Cadbury. Unlike with SAS600, it is not possible in this instance to tell in any particular case whether SAS130 audit procedures had been implemented prior to the standard becoming mandatory, although there are good reasons to believe publication date is the most likely implementation date.[12] However, to allow for alternative SAS130 adoption dates, we also undertake four additional regressions runs.

### *3.3.2 Variables*

Based on an analysis of the relevant theory, UK auditing guideline indicators and the literature reviewed in Chapter 2, section 2.4 we hypothesise the following control variables may impact on the audit going concern disclosure decision. They therefore need to be controlled for in seeking to examine the impact of the new auditing standards and Cadbury.

Previous research uniformly demonstrates that the probability of financial distress/bankruptcy is the key determinant of a going concern audit disclosure (e.g. Citron and Taffler, 1992 and 1999; Mutchler *et al.*, 1997; McKeown *et al.*, 1991; Louwers, 1998; Carcello *et al.*, 1995, and Johnson and Khurana, 1995; Holder-Webb and Wilkins, 2000).

[12] Carcello *et al*. (1997) revolves around this key issue which is discussed in more detail in Chapter 6.

To control for the underlying financial risk of the business we use the UK-based linear discriminant z-score models of Taffler (1984), which are widely used measures for the prediction of financial distress. In addition, proxying for UK audit guideline and standard financial indicators summarised in Table 2.1, we incorporate dummy variables to represent net worth (positive/negative), net working capital (positive/negative), dividend (cut or absent) and profit/loss before interest and tax, together with gearing to measure the financial risk of the business.[13]

We also expect size of firm to impact on the nature of the audit report going concern disclosure, in line with earlier studies as discussed in Chapter 2, section 2.4, although the expected sign is problematic. Are larger firms better able to weather financial difficulties (Mutchler *et al*., 1997) and/or have greater bargaining power with their auditors, thereby decreasing the likelihood of going concern disclosures? Alternatively, because such firms are more visible, does the auditor have an interest in appropriate disclosure because of the potential adverse impact on auditor reputation if the company subsequently fails without warning (e.g. Citron and Taffler, 1999)? We use 1n (total assets) as our measure of company size.

*A priori*, the longer the period between year end and audit report signing date, the greater the likelihood of going concern negotiations and increased audit procedures (Mutchler *et al*., 1997; McKeown *et al*., 1991; Carcello *et al*., 1995 and Raghunandan and Rama, 1995). However, it is not just the lag but also change over the previous year's lag which may be an indicator of potential problems that need to be controlled for. But since the likelihood is that change in lag will be associated with the existence or otherwise of a going concern disclosure in the prior period, only one of these measures is required. Mutchler (1985) and Lennox (1999) find the presence of previous audit report going concern qualifications to be highly significant in their studies. We adopt a parallel approach.

We also introduce an auditor size dummy even though the literature finds this not to be a significant determinant of going concern audit disclosures (e.g. Mutchler *et al*., 1997; Krishnan and Krishnan, 1996 and Citron and Taffler, 1999).

[13] Lennox (1999), Krishnan and Krishnan (1996) and Raghunandan and Rama (1995) find gearing to be significant.

In an attempt to control for the different environmental factors that might impact on the likelihood of company financial distress, and thus audit report going concern disclosure rates, we use the GDP forecast as a measure of the expected state of the economy.[14,15]

We also introduce dummies for different industry sectors as the vulnerability of a sector as a whole might have a differential impact on going concern disclosure rates. Also, specific to our study, separate dummies for the three different z-score models used for analysing different categories of firm[16] are employed to take account of any potential differences in model mean z-scores.

To test hypothesis $H_{03}$ we focus on all post-Cadbury cases in our population which have a going concern modification. Specifically, we investigate whether directors' Cadbury going concern disclosures are consistent with their companies' GCM status. We also examine whether any inconsistencies between directors disclosures and the modified audit reports are related to measures of company risk and, in addition, whether auditor reviews highlight such inconsistencies.

### 3.4 Sample selection

To identify firms at risk of financial distress we adopt the widely used multivariate z-score model approach which explicitly measures the probability of firm failure. This provides a more comprehensive indicator than alternative less discriminatory proxies used in some other studies (e.g. Raghunandan and Rama, 1995; Carcello *et al*., 1997) such as losses, cessation of dividends or negative working capital which only measure individual aspects of the firm's financial profile. In addition, as the z-score is a key predictor of audit report going

14 This is a six months ahead forecast published annually in the Treasury's *Financial Statement and Budget Report.* The forecast employed relates to the period in which the audit report is signed as indicative of relevant economic conditions pertaining at that time. During the period of our study the annual GDP growth rate varied between a minimum of –2.5% and a maximum of 4%, clearly necessitating the inclusion of such a specific variable.

15 Lennox (1999) finds an economic cycle measure to be significant in his bankruptcy prediction model but not in his GCQ model. Raghunandan and Rama (1995) test for the impact of macroeconomic factors by comparing company failure rates before and after the introduction of SAS No. 59. They find no difference in these rates and so conclude that their findings are not affected by economy-wide influences, although they do not include this measure in their regression model.

16 Industrial, retail and service activities. Taffler (1984) reports on the first two linear discriminant models, the third model is unpublished but very similar in nature. The respective component model financial ratios are: earnings before tax/current liabilities, current assets/total liabilities, current liabilities/total assets and no-credit interval (industrial firm model); cash flow/total liabilities, debt/quick assets, current liabilities/total assets and no-credit interval (retail firm model); and earnings before tax/total liabilities, current assets/capital employed, current liabilities/sales and (quick assets-current liabilities)/total assets (service firm model). For all models z = 0 is set as the cut-off between financial solvency and risk of financial distress.

concern uncertainty disclosures it is able to generate an appropriate population for our purposes.[17]

All UK listed and USM non-financial companies with financial year-ends falling between 31.12.91 and 31.12.96 with negative z-scores constitute the relevant population of firms used in this research. There are 1669 company year reports meeting these criteria.

For all companies in this population audit report disclosures are then identified using the Dialog Corporation CD-ROM *UK Company Factfinder* database of company annual reports and appropriate keyword searches.[18] We are unable to ascertain audit report dates for 19 cases leaving 1650 (98.9%) with total data availability which are used for the logistic regressions reported in Chapters 5 and 6. Of these 213 (12.9%) company year reports have explicit mention in their audit reports of going concern uncertainties.

The failure probability measure we use comes from the Syspas Ltd. database of company z-scores together with model dummy, and the main accounting information is drawn from the Extel *Company Analysis* database. Other variables, including auditor and audit lag, are taken directly from the company accounts in the Dialog database. The industry sector groupings are derived from the FT/Actuaries classification system.

## 3.5 Summary

This chapter sets out the objectives and underlying hypotheses of our study. We also describe our methodology. To test the impact of the two auditing standards of interest and Cadbury on going concern audit report disclosure rates we use a set of logistic regression models. Our reasons for model formulation and choice of control variables are described.

We also describe our approach to investigating the consistency of directors' Cadbury disclosures with audit report status for the subset of our population with GCMs, as well as the extent to which auditors draw readers' attention to any inconsistencies between the two.

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17 See the papers referenced in Chapter 3, section 3.3.2 above.

18 For pre-SAS600 audit reports the specific word searches used were 'going concern … subject to' (GCQs) and 'going concern … we draw your attention' (EOMs). For post-SAS600 cases 'going concern … not qualified' and 'our opinion … not qualified' with in this case 'going concern' specified elsewhere in the audit report (GCMs).

The next chapter provides more detail on our sample and reports on a univariate analysis of the key variables of interest.

# Chapter 4: Population characteristics

## 4.1 Introduction

This chapter describes our population of financially distressed firms and reports the going concern disclosure rates, state of the economy and company characteristics prevailing under different going concern auditing regimes. Industry and auditor profiles are also considered. Univariate tests of differences in firm size, performance and risk between firms with GCQ, EOM or GCM audit reports and those without are conducted.

## 4.2 Going concern reporting patterns under different auditing regimes

How does the rate of reporting of going concern uncertainties vary as audit reporting style and auditing procedures change?

Our analysis focuses on the population of 1669 cases of negative z-scores among all fully listed and USM non-financial firms with financial year ends between 31.12.91 and 31.12.96 inclusive. In total there are 213 cases of explicit mention in the audit report of going concern uncertainties representing 12.8% of our 1669 financially distressed company cases.

Of these 213 cases 47, or 22.1%, are going concern qualifications for the pre-SAS600 auditing regime, and a further 8 (3.7%) are emphases of matter. The remaining 158 cases (74.2%) are going concern modifications post the introduction of SAS600.

Table 4.1 breaks down the going concern disclosure rates by pre- and post-SAS600 audit regimes. Each of these classifications is separately divided into columns reflecting when the auditing standard was voluntary or mandatory. In addition, the post-SAS600 results for the mandatory period are separately analysed in three columns, depending on the status of SAS130. The time line of Table 1.1 in Chapter 1 shows visually when the different regimes apply, and these are also summarised at the foot of Table 4.1

**Table 4.1 Audit report going concern disclosures among listed and USM negative z-score companies for 31.12.91 – 31.12.96 period ends**

| | **Pre-SAS 600 style** | | | **Post-SAS600 style** | | | | | **Grand total** |
|---|---|---|---|---|---|---|---|---|---|
| | Mandatory[1] | Transition[2] | Total | Transition[2] | Mandatory | | | Total | |
| | | | | Pre-SAS130[3] | Pre-SAS130[3] | SAS130 Transition Period[4] | Post-SAS130[5] | | |
| Number of cases | 436 | 102 | 538 | 77 | 287 | 266 | 501 | 1131 | 1669 |
| Emphases of matter | 6 (1.4%) | 2 (2.0%) | 8 (1.5%) | - | - | - | - | - | 8 |
| Going concern qualifications | 33 (7.5%) | 14 (13.7%) | 47 (8.7%) | - | - | - | - | - | 47 |
| Going concern modifications | - | - | - | 27 (35.1%) | 38 (13.2%) | 35 (13.2%) | 58 (11.6%) | 158 (14.0%) | 158 |
| Total going concern disclosures | 39 (8.9%) | 16 (15.7%) | 55 (10.2%) | 27 (35.1%) | 38 (13.2%) | 35 (13.2%) | 58 (11.6%) | 158 (14.0%) | 213 (12.8%) |

[1] Pre-SAS600 mandatory cases: audit report dated 31 May 1993 or earlier.
[2] Pre- and post-SAS600 transition period cases: audit report dated after 31 May 1993 but year end 29 September 1993 or earlier.
[3] Pre-SAS130 cases: year end 29 September 1994 or earlier.
[4] SAS130 Transition Period cases: year end between 30 September 1994 and 29 June 1995 inclusive.
[5] Post-SAS130 cases: year end 30 June 1995 or later.

The SAS130 transition and post-SAS130 periods closely approximate when the Cadbury Guidance was effective.

### *4.2.1 Impact of SAS600*

How do going concern disclosure rates differ pre-SAS600 from post-SAS600? Pre-SAS600, when the economy was weaker, far more firms were at risk of financial distress and company failure rates were far higher. 10.2% of companies with negative z-scores had going concern qualifications or equivalent emphases of matter.[19] This compares with 14.0% post-SAS600, where the economy was much stronger, which result is significant at better than $\alpha = 0.05$ using the test of sample proportions ($z_{calc} = 2.29$). Importantly, Table 4.1 also highlights the striking picture presented when adoption of SAS600 was voluntary. During this period, covering 179 audit reports dated after 31.5.93 but with financial year ends before the 30.9.93, auditors electing to report in accordance with SAS600 were more than twice as likely to disclose going concern uncertainties as those reporting in line with pre-SAS600 style. The respective rates of 35% and 16% differ at better than $\alpha = 0.01$ using the test of sample proportions ($z_{calc} = 2.94$).

Removing the apparently atypical SAS600 transition period results, the 8.9% GCQ rate for the mandatory pre-SAS600 style audit report for audit reports dated 31.5.93 or earlier compares with the 12.4% GCM rate for the mandatory post-SAS600 audit regime for year ends 30.9.93 onwards. This difference is significant at $\alpha = 0.05$ using the test of sample proportions ($z_{calc} = 2.06$).[20]

These results are consistent with our initial hypothesis that, on a face value basis, the nature of the revised audit report makes it easier for the auditor to disclose going concern uncertainties, although more definitive conclusions can only be drawn after controlling for other factors that might impact on such results. This analysis is conducted in the next chapter.

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[19] For our pre-SAS600 period, effectively calendar years 1991 and 1992, GDP growth averaged -1.5%/year compared with an average positive growth rate of 2.75%/annum over the next four years. Similarly, average percentages of companies with negative z-scores were 26% and 20% and failure rates per year averaged 37 against 4.

[20] The reasons for the exceptionally high GCQ/GCM rate during this short transition period can only be speculated upon. They may reflect the particularly parlous financial profiles of firms reporting during this period, as Table 4.2 highlights. Additionally, the promulgation of SAS600 may have made auditors more sensitive to audit report modification issues, GCMs included.

### *4.2.2 Impact of SAS130*

Did the introduction of SAS130 impact further on GCM rates? The second panel of Table 4.1 explores this. A straight comparison between pre-SAS130 and post-SAS130 cases apparently indicates a sharp reduction in GCM rates from 17.9% to 11.6%, with the transition period excluded.[21] Ignoring the unusually high GCM rates prevailing prior to mandatory adoption of SAS600, there is still no evidence of any increase (13.2% v 11.6%). On this basis, SAS130 would appear to have had no incremental impact on going concern disclosure rates. However, any such conclusion, again, must await more detailed analysis taking into account the changed nature of the economy in the later period and other factors that might impact on GCM rates. This analysis is conducted in Chapter 6.

## 4.3 Firm characteristics and the economic environment

Table 4.2 compares balance sheet profiles, performance indicators and firm z-scores over time broken down by audit regime.

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[21] There are 364 pre-SAS130 negative z-score cases of which 65 have GCM audit reports, i.e. 17.9%.

**Table 4.2 Distressed company financial characteristics among listed and USM negative z-score companies for 31.12.91 – 31.12.96 period ends**

| | **Pre-SAS 600 style** | | | **Post-SAS600 style** | | | | | | Grand total |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | Transition | Mandatory | | | | Total | |
| | Mandatory | Transition | Total | Pre-SAS130 | Pre-SAS130 | SAS130 Transition Period | Post SAS130 | Total | | |
| | (n = 436) | (n = 102) | (n = 538) | (n = 77) | (n = 287) | (n = 266) | (n = 501) | (n = 1054) | (n = 1131) | (n = 1669) |
| **Panel A: Balance Sheet Indicators** | | | | | | | | | | |
| Gearing - mean | 0.81 | 1.39 | 0.92 | 0.93 | 0.86 | 0.85 | 0.87 | 0.86 | 0.87 | 0.89 |
| - median | 0.71 | 0.75 | 0.71 | 0.81 | 0.74 | 0.77 | 0.76 | 0.76 | 0.76 | 0.74 |
| % with negative net worth | 12.1 | 24.0 | 14.3 | 19.5 | 17.4 | 15.4 | 16.6 | 16.5 | 16.7 | 15.9 |
| % with negative net current assets | 40.0 | 45.0 | 40.9 | 63.6 | 42.9 | 45.5 | 38.1 | 41.3 | 42.8 | 42.2 |
| **Panel B: Performance Indicators** | | | | | | | | | | |
| % with operating loss | 42.9 | 49.0 | 44.1 | 61.0 | 40.4 | 37.6 | 38.3 | 38.7 | 40.2 | 41.5 |
| % with loss after exceptionals | 53.4 | 61.0 | 54.8 | 68.8 | 45.6 | 39.1 | 40.7 | 41.6 | 43.5 | 47.2 |
| % with dividend cut or zero dividend | 72.9 | 78.0 | 73.9 | 85.7 | 66.1 | 55.7 | 55.4 | 58.3 | 60.2 | 64.6 |
| **Panel C: Z-scores** | | | | | | | | | | |
| Mean | -4.30 | -6.04 | -4.63 | -6.58 | -4.12 | -3.66 | -3.86 | -3.88 | -4.06 | -4.24 |
| Median | -3.15 | -4.75 | -3.30 | -4.74 | -2.73 | -2.33 | -2.81 | -2.64 | -2.74 | -2.94 |

The audit report style periods are defined in Table 4.1.
Gearing is the ratio of total liabilities to total tangible assets.
Net worth is shareholder funds net of minority interests and intangibles.
Net current assets is current assets minus creditors due within one year.
Operating profit/loss is before exceptional items and before interest.
Profit/loss after exceptionals is before interest.
Dividends are the ordinary dividends.
A company's z-score represents its risk of failure as measured by a statistical model using a combination of financial ratios as independent variables. If the score is negative the company has a financial profile similar to previously failed companies and as such is itself 'at risk'. The more negative the score the weaker its financial position.

Not surprisingly, since all our firms have negative z-scores, the final column shows the overall profile of our firms to be consistent with that of a financially distressed population. A large proportion of companies have negative net worth or net current assets, gearing levels are very high, almost 50% of firms are making losses, and mean z-score is very negative. In addition, in two thirds of cases dividends have been cut or are zero.

Does this profile vary over the time-frame we examine in a way that might help us explain the clear differences in disclosure rates across the different auditing regimes? As can be seen from the table, no clear pattern emerges save that the SAS600 transition period firms appear far more distressed than those for the two surrounding mandatory periods. For example, the median z-score, which provides the best overall measure of the degree of financial distress, for this transition period of -4.7, is far more negative than the median z-score of -3.2 prior to the publication of SAS600 and even more so than the improved median z-score of -2.6 once SAS600 is mandatory. The other financial indicators provide a qualitatively similar picture.

A comparison of the two mandatory periods suggests some slight improvement in firm financial profiles in aggregate in line with the strengthening of the economy post-SAS600. C*eteris paribus*, this gravitates against an increase in GCM rates so strengthening any conclusions about the positive impact of SAS600 were we to confirm our initial findings of an increase in audit report disclosure rates in our logistic regression analyses in the next chapter.

With regard to changes in firm profiles prior to the publication of SAS130 and post-implementation, no clear pattern emerges. Again the impact of the economy and other relevant variables on GCM rates surrounding the introduction of SAS130 needs to await the detailed logistic regression analyses in Chapter 6.

We would expect that an auditor’s beliefs about the financial viability of a client will to some extent reflect his/her views on the future state of the economy. To this end Table 4.3 provides the Treasury’s GDP forecast averaged across firms broken down by different reporting styles. The average GDP forecast increase for the pre-SAS600 firms is 1.6%, just over half the figure of 3% for the post-SAS600 regime. Thus, as we have already shown, the increased post-SAS600 disclosure rates cannot be explained by changes in the economic environment.

**Table 4.3 Economic indicators for listed and USM negative z-score companies for 31.12.91 – 31.12.96 period ends**

| | **Pre-SAS 600 style** | | | **Post-SAS600 style** | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Mandatory | Transition | Total | Transition | Mandatory | | | Total (n= 1131) | Grand total (n= 1669) |
| | (n= 436) | (n= 102) | (n= 538) | Pre-SAS130 (n= 77) | Pre-SAS130 (n= 287) | SAS130 Transition Period (n= 266) | Post-SAS130 (n= 501) | | |
| GDP forecast indicator | 1.5% | 2.2% | 1.6% | 2.5% | 2.8% | 2.7% | 3.3% | 3.0% | 2.6% |

The GDP forecast indicator is the Treasury's semi-annual GDP forecast published in its *Financial Statement and Budget Report*.

A value for this indicator is attached to every case in our population, being the value prevalent at the date of signing the audit report. The values in the above table are the mean values of the indicator attached to each case in the column.

The audit report style periods are defined in Table 4.1

With regard to the incremental impact of SAS130 on GCM rates, there is some weak evidence of an improvement in economic expectations with the average GDP forecast indicator for the mandatory pre-SAS130 and post-SAS130 periods rising from 2.8% to 3.3%. There is also a small decline in going concern uncertainty reporting rates from 13.2% to 11.6%. A more considered analysis again has to await discussion in Chapter 6.

## 4.4 Industry and auditor analysis

Table 4.4 breaks down our population of 1669 negative z-score cases by broad industry sector and compares the different going concern disclosure rates. The greatest number of such cases are in the general industrial and services sectors, but the highest going concern disclosure rates are in property, resources and utilities; although in the latter case there are only 12 such firms with negative scores.

### Table 4.4 Going concern disclosures by industry

| Industry sector[1] | Total number of cases | | % with going concern disclosure |
|---|---|---|---|
| | n | % | |
| General industrial | 591 | 35.4 | 8.3 |
| Consumer goods | 237 | 14.2 | 11.5 |
| Services | 567 | 34.0 | 14.1 |
| Property | 205 | 12.3 | 17.2 |
| Resources | 57 | 3.4 | 24.6 |
| Utilities | 12 | 0.7 | 58.3 |
| Total | 1669 | 100.0 | 12.8 |

Going concern disclosure cases comprise cases with a GCQ, an EOM or a GCM.

[1] Sectors are FTSE Actuaries Industry Sector groupings

Table 4.5 breaks down the population by auditor in terms of the Big 6 firms[22] and non-Big 6 firms grouped together, which latter account for just over a quarter (26.3%) of cases.

**Table 4.5 Going concern disclosures by auditor**

| Auditor | Total number of cases n | % | % with going concern disclosure |
|---|---|---|---|
| Arthur Andersen | 91 | 5.5 | 11.0 |
| Coopers & Lybrand | 219 | 13.2 | 9.1 |
| Deloitte and Touche | 198 | 11.9 | 12.1 |
| Ernst and Young | 173 | 10.4 | 12.1 |
| KPMG | 384 | 23.1 | 11.2 |
| Price Waterhouse | 161 | 9.7 | 9.9 |
| All Big 6 | 1226 | 73.7 | 10.9 |
| Non-Big 6 | 438 | 26.3 | 17.4 |
| Total | 1664 | 100.0 | 12.6 |

Going concern disclosure cases comprise cases with a GCQ, an EOM or a GCM.

$\chi^2_{calc}$ using all the above data (7x2 table) = 13.36 (significance = .038 for 6 degrees of freedom).

Eliminating the non-Big 6 cases (6 x 2 table), $\chi^2_{calc}$ = 1.47 (significance = .917 for 5 degrees of freedom).

$\chi^2_{calc}$ for Big 6 vs non-Big 6 = 11.49 (after continuity correction) (significance = .001 for 1 degree of freedom).

22 The merger between Price Waterhouse and Coopers & Lybrand occurred after the end of our sample period.

Whereas there is no difference in going concern uncertainty disclosure rates across the Big 6[23], the GCM/GCQ rates for non-Big 6 firms are much higher at 17.4% compared with only 10.9% for the Big 6. This difference is significant at better than $\alpha = 0.001$ applying the appropriate $\chi^2$ test ($\chi^2_{calc} = 11.5$, $\chi^2_{crit}$ $\{\alpha = 0.001\} = 10.83$). Although this difference is difficult to interpret it may be, *inter alia*, a function of client size.[24] This relationship is taken into account in our multivariate analyses in the next two chapters.

## 4.5 Differences between GCQ/GCM and non-GCQ/GCM firms

The final three tables break down our population on the basis of differences in going concern disclosure by company size, profitability and risk.

Table 4.6 compares those firms with going concern audit report disclosures against those without in terms of total assets, market capitalisation and net worth. As can be seen, there are significant differences across all three measures at better than the 0.1% level, save in the case of mean total assets. Firms with no going concern disclosures are far larger on average, being almost four times the size of the GC cases in terms of mean market capitalisation, and more than seven times the size in terms of net worth. Median figures provide a similar picture, but now the median firm with no going concern disclosure is also 2.5 times the size of the going concern cases in terms of total assets.

23 There is no difference within the Big 6 firm audit segment (p = 0.92 using the $\chi^2$ test).

24 The simple correlation between Big 6/non-Big 6 binary variable and client size as measured by 1n(total assets) = 0.27, which is significant at $\alpha = 0.001$.

**Table 4.6 Measures of company size (£ millions)**

| | Total assets | | Market capitalisation | | Net worth | |
|---|---|---|---|---|---|---|
| | With GC disclosure | No GC disclosure | With GC disclosure | No GC disclosure | With GC disclosure | No GC disclosure |
| Mean (£m) | 111.3 | 98.0 | 12.7 | 46.9 | 2.9 | 21.9 |
| Standard deviation (£m) | 251.1 | 185.6 | 34.3 | 89.2 | 20.8 | 42.3 |
| n | 193 | 1393 | 181 | 1384 | 199 | 1387 |
| t-statistic | 0.7 | | 9.8* | | 10.3* | |
| Median (£m) | 12.5 | 31.9 | 4.7 | 13.7 | 0.02 | 8.1 |
| n | 213 | 1456 | 205 | 1442 | 213 | 1456 |
| $\chi^2$ | 22.9* | | 66.9* | | 90.5* | |

* indicates differences are significant at better than the 0.1% level.

The data for the means are after trimming outliers (the largest and smallest 2.5% of cases for each variable).

On this basis it would appear that smaller firms, possibly because they are less visible or the negotiations surrounding going concern disclosures provide relative power advantage to the auditing firm, have higher disclosure rates. Alternatively, they may be that much financially weaker so that their disclosure rate is higher. McKeown *et al*. (1991) and Mutchler *et al*. (1997) find an equivalent result with their US samples, which they attribute to similar factors. Citron and Taffler (1999), however, find no such relationship in their study of GCQs among subsequently failing firms in the UK.

Table 4.7 provides mean and median profitability measures for firms with and without going concern disclosures in their audit reports.

**Table 4.7 Measures of company profitability**

| | **Ratio of profit before exceptional items, interest and taxation to total assets** | | **Ratio of profit after exceptional items but before interest and taxation to total assets** | |
|---|---|---|---|---|
| | With GC disclosure | No GC disclosure | With GC disclosure | No GC disclosure |
| Mean | -0.14 | -0.00 | -0.24 | -0.04 |
| Standard deviation | 0.18 | 0.12 | 0.27 | 0.18 |
| n | 188 | 1398 | 178 | 1408 |
| t-statistic | 10.3* | | 9.8* | |
| Median | -0.13 | 0.03 | -0.21 | 0.02 |
| n | 213 | 1456 | 213 | 1456 |
| $\chi^2$ | 87.7* | | 93.3* | |

* indicates differences are significant at better than the 0.1% level.

The data for the means are after trimming outliers (the largest and smallest 2.5% of cases for each variable).

As can be seen, the average firm with going concern disclosure has losses of 14% of total assets on an operating profits basis, compared with break-even for negative z-score firms with no going concern disclosure. The equivalent figures for operating profit after exceptional items are -24% compared with –4%, highlighting the very large negative exceptional items in cases of disclosed going concern uncertainties. The median figures provide a very similar picture. Our evidence, that heavy losses are a necessary condition for drawing attention to going concern uncertainties in the audit report, is consistent with extant research in both the US and UK (e.g. Raghunandan and Rama, 1995; Citron and Taffler, 1999).

Table 4.8 provides a similar cross-sectional comparison for measures of company risk in terms of gearing (measured by total liabilities/total assets), working capital (net current assets/total assets) and finally z-score.

**Table 4.8 Measures of company risk**

| | Gearing (Total liabilities/Total assets) | | Net current assets/ Total assets | | Z-score | |
|---|---|---|---|---|---|---|
| | With GC disclosure | No GC disclosure | With GC disclosure | No GC disclosure | With GC disclosure | No GC disclosure |
| Mean | 1.04 | 0.77 | -0.21 | 0.02 | -8.59 | -3.43 |
| Standard deviation | 0.34 | 0.25 | 0.31 | 0.21 | 3.68 | 3.01 |
| n | 188 | 1398 | 178 | 1408 | 173 | 1413 |
| t-statistic | 10.8* | | 9.5* | | 17.7* | |
| Median | 0.99 | 0.72 | -0.25 | 0.05 | -8.96 | -2.47 |
| n | 213 | 1456 | 213 | 1456 | 213 | 1456 |
| $\chi^2$ | 114.7* | | 71.9* | | 1517* | |

* indicates differences are significant at better than the 0.1% level.

The data for the means are after trimming outliers (the largest and smallest 2.5% of cases for each variable).

As can be seen, all three measures demonstrate the higher risk of financial distress for firms with going concern disclosures, with all differences significant at the 0.1% level. On average, gearing is a third higher for going concern cases, working capital is on average -20% of total assets compared with +2% for the non-going concern cases and the average z-score of -8.6 is more than twice as negative as that for the no disclosure cases, with mean of –3.4. On this basis it is clear, once again, that only firms at acute financial risk have their going concern uncertainties highlighted in the audit report.

## 4.6 Summary

This Chapter looks at the pattern of audit report going concern disclosures across the old and new auditing regimes and finds an increased rate of disclosures post-SAS600. We find no evidence that any difference in relevant company characteristics across the two audit regimes considered on a univariate basis or the state of the economy might be driving these results.

On the other hand, we have no evidence that the issuance of SAS130, the going concern auditing standard, has had any incremental positive impact on going concern disclosure rates.

We find some industry concentration in terms of going concern disclosure rates in property, natural resources and utilities, although as a proportion of our sample these industries only account for 16% of the 1669 cases. Interestingly, we find that there is no difference in disclosure rates within the Big 6 auditor segment, but there is a very statistically significant difference between Big 6 and non-Big 6 audit firms considered on a univariate basis with non-Big 6 GCQ/GCM rates 60% higher.

We also find that companies with going concern disclosures are very much smaller than those without, and are very heavily loss making compared with, on average, a break-even position among non-GC disclosure firms. In addition, they are at much higher risk of financial distress as measured by their gearing and working capital position and, most importantly, their z-score.

Our results are consistent with the ‘borderline-failure hypothesis’ of McKeown *et al*. (1991) who argue that only in very clear cases of acute financial distress do firms’ audit reports disclose going concern uncertainties.

Our findings, on this univariate basis, are consistent with the hypothesis that the new SAS600 audit report style has had a positive impact on going concern disclosure rates, although not consistent with the second hypothesis, that the enhanced auditing process associated with SAS130 would lead to a higher rate of going concern disclosures.

Nonetheless, because of the range of considerations that an auditor might take into account in the GCQ/GCM decision, and the complex set of interactions among these, no clear conclusions can be drawn from the univariate analyses of this chapter.

The next chapter reports on our logistic regression results exploring the impact of the introduction of SAS600 on audit going concern disclosure rates. Chapter 6 provides a related analysis of the incremental impact of SAS130/Cadbury.

# Chapter 5: The impact of SAS600 *Auditors' Reports on Financial Statements* on going concern disclosure rates

## 5.1 Introduction

In Chapter 4 we looked at initial evidence of the response by auditors to the issuance of SAS600 and find *prima facie* evidence that the new auditing standard has had a measurable impact on going concern audit report disclosure rates. However, there are many factors at work that will influence auditors' disclosures and it is necessary to consider the evidence within a multivariate context.

Our first hypothesis $H_{01}$, relating to the impact of SAS600, is laid out in null form in sub-section 3.2.1 of Chapter 3:

$H_{01}$ *There is no increased rate of audit report going concern disclosure post-SAS600 compared with the pre-SAS600 period.*

We test this hypothesis explicitly in this chapter using logistic regression model 1 which is described in sub-section 3.3.1 of Chapter 3.

## 5.2 The logistic regression runs

Four different runs are undertaken depending on the treatment of the transition period and introduction of SAS130. Table 5.1 details the different sub-samples.

**Table 5.1 SAS600 Logit Analytical Schema**

| | | Pre-SAS 600 style | | Post-SAS600 style | | | |
|---|---|---|---|---|---|---|---|
| | | | | | Mandatory | | |
| Logit analysis | No. of cases | Mandatory | Transition | Transition Pre-SAS130 | Pre-SAS130 | SAS130 Transition Period | Post-SAS130 |
| 1 (All cases) | 1650 | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ |
| 2 (Mandatory) | 1471 | ✓ | | | ✓ | ✓ | ✓ |
| 3 (Pre-SAS130) | 895 | ✓ | ✓ | ✓ | ✓ | | |
| 4 (Mandatory pre-SAS130) | 716 | ✓ | | | ✓ | | |

✓ indicates companies with audit reports in the period indicated are included in the relevant regression

The first run includes all 1650 cases with full data availability. The second row of Table 5.1 relates to 1471 cases with the transition period when firms were able to report using pre-SAS600 or SAS600 audit report style omitted.

The removal of this short period and a small number of cases (179) is motivated by the need to avoid the potential for specific transition period effects associated with the introduction of a new and radical audit regime. In addition, as sub-section 4.2.1 of Chapter 4 indicates, there was a very high going concern uncertainty disclosure rate during this period. Also, as section 4.3 highlights, firms reporting during this period appear to be more financially distressed.

The third run, with a sub-sample of 895 cases, examines the impact of SAS600 on its own with analysis restricted to the pre-SAS130 publication period to avoid any potential distorting effect of SAS130/Cadbury. The last row omits both the post-SAS130 cases and the SAS600 changeover period leaving a sub-sample of 716 cases.

## 5.3 Empirical results

Table 5.2 provides the results of the four regression analyses where the logit dependent variable = 0 if no going concern audit report disclosure, and = 1 if there is a going concern qualification, emphasis of matter for going concern reasons or going concern modification. The focus of our analysis is on the significance of the SAS600 binary variable (= 1 if SAS600 style and 0 if pre-SAS600 style) and its impact on the going concern dependent variable after taking into account the other potentially confounding independent measures in the model.

## Table 5.2 Logistic regression of going concern disclosure on SAS600, company performance and economic indicator variables

| | Predicted sign | 1 All cases | | 2 Excluding SAS 600 Transition period cases | | 3 Excluding cases after SAS130/ Cadbury published | | 4 Excluding SAS600 transition period and cases after SAS130/Cadbury published | |
|---|---|---|---|---|---|---|---|---|---|
| | | Coefficient | Significance of Wald Statistic | Coefficient | Significance of Wald Statistic | Coefficient | Significance of Wald Statistic | Coefficient | Significance of Wald Statistic |
| SAS600 | + | 1.47 | .000 | 1.11 | .018 | 1.56 | .000 | 1.07 | .075 |
| Z | - | -0.09 | .001 | -0.13 | .000 | -0.12 | .001 | -0.23 | .000 |
| NETWORTH | - | -0.49 | .068 | -0.52 | .087 | -0.32 | .370 | -0.35 | .427 |
| NETWCAP | - | -0.58 | .012 | -0.50 | .056 | -0.72 | .020 | -0.60 | .126 |
| GEAR | + | 0.10 | .417 | 0.01 | .971 | 0.11 | .437 | -0.13 | .601 |
| DIV | - | -8.42 | .431 | -8.14 | .461 | -7.45 | .445 | -7.92 | .647 |
| PBIT | - | -0.53 | .036 | -0.48 | .088 | -0.23 | .498 | -0.05 | .901 |
| ASSETLOG | ? | 0.31 | .028 | 0.17 | .275 | 0.40 | .030 | 0.18 | .443 |
| AUDITLAG | + | 0.01 | .000 | 0.01 | .000 | 0.01 | .000 | 0.01 | .000 |
| $QUAL_{t-1}$ | - | -1.57 | .000 | -1.67 | .000 | -1.31 | .000 | -1.45 | .001 |
| BIG-6 | ? | 0.23 | .301 | 0.24 | .341 | 0.23 | .437 | 0.26 | .472 |
| GDPFCAST | - | -0.39 | .034 | -0.24 | .282 | -0.49 | .031 | -0.26 | .374 |
| CONSUMER | ? | -0.33 | .327 | -0.18 | .637 | -0.04 | .930 | 0.19 | .766 |
| PROPERTY | ? | -0.96 | .011 | -0.96 | .025 | -1.35 | .005 | -1.63 | .008 |
| RESOURCES | ? | -0.79 | .098 | -0.82 | .128 | -0.76 | .201 | -0.79 | .294 |
| SERVICE | ? | -0.41 | .208 | -0.45 | .214 | -0.59 | .182 | -0.87 | .113 |
| UTILITY | ? | -1.81 | .033 | -1.70 | .054 | -1.95 | .036 | -1.84 | .071 |
| MODELA | ? | -0.00 | .990 | 0.02 | .961 | 0.15 | .753 | 0.33 | .566 |
| MODELB | ? | 0.55 | .066 | 0.57 | .084 | 0.92 | .021 | 1.26 | .012 |
| CONSTANT | ? | 1.01 | .478 | 0.79 | .612 | 0.40 | .823 | -0.09 | .966 |
| No. of cases | | 1650 | | 1471 | | 895 | | 716 | |
| Model $\chi^2$ | | 554.18 | | 471.30 | | 301.24 | | 224.82 | |
| $\chi^2_{sig.}$ | | .000 | | .000 | | .000 | | .000 | |
| $R_L^2$ | | 43.7% | | 44.9% | | 42.7% | | 46.0% | |

See Table 3.1 for variable definitions

The SAS600 binary variable is uniformly significant across all four runs, in two of the formulations at a significance level of better than 0.1%.[25] On this basis, the SAS600 new style audit report has had a very material and positive impact on going concern disclosure rates.

This is emphasised by noting the relative importance of the SAS600 variables in terms of the exponentiated value of its logit coefficient. This denotes the amount by which the odds ratio [p/(1-p)] increases with the implementation of SAS600, *ceteris paribus*, where p is the probability of a GCQ/GCM for our population of financially distressed firms.

For example, in the case of run 2, which excludes the unusual transition period, the odds ratio is exp (1.1) = 3.0, i.e. the odds ratio increases by a factor of three when SAS600 becomes mandatory. What this means is that where p = 8.9% for the strict pre-SAS600 period (see first column, Table 4.1), holding everything else constant, p would now be 21%, i.e. more than twice as high.[26]

In fact, the actual GCM rate for the mandatory post-SAS600 period is 12.4%,[27] which represents only a one-third increase on the pre-SAS600 GCQ rate of 8.9%. However, as Table 4.3 illustrates, the economy was very significantly stronger in the later period and, in fact, the GDP forecast variable is correlated at 0.79 with the SAS600 binary measure. The 21% forecast rate following the implementation of SAS600 is on the basis of no change in other relevant factors.

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[25] The four pseudo -$R^2$ ($R_L^2$) statistics are all greater than 40% suggesting good overall explanatory power.

[26] Where p´ is the new probability of a GCQ/GCM, $\frac{p'}{(1-p')}$ = 0.089 x 3, so p´ = 0.21.

[27] Derived from Table 4.1, columns 5-7.

Considering the other independent variables significant across the four runs, we can see how the actual disclosure decision is dominated by the degree of financial distress of the firm, as measured by its z-score (significant at better than the 0.1% level). Audit lag and previous year GCQ/GCM are equally significant. The longer the delay between financial year-end and audit report signing, the more likely a GCQ/GCM, which is consistent with prior expectations. Increased audit procedures and the negotiations with management, together with the time required to obtain reassurance from the company's bankers and other parties, would appear to lead to an extended audit. Similarly, previous year going concern audit report disclosures are, not surprisingly, associated with continuing going concern problems in the following year.

In addition, we might expect that given the agreement of directors to the previous year's going concern disclosures in the audit report, they would be less resistant to its recurrence. Other variables, generally significant at conventional levels across all four runs, include the net working capital binary variable, two of the sectoral measures, property and utility, and the service sector z-score model binary (MODELB).[28]

The SAS600 binary variable is significant at better than the 0.1% level in the 1650 all case run. The results of the second logistic analysis (column 2) with 1471 cases, omitting the short transition period where auditors and firms could choose their style of audit report, are very similar in substantive terms with the SAS600 measure now significant at the 2% level. This confirms that the all case results are not distorted by the transition period and the high profile of the new auditing standard.

If analysis is restricted to the 895 pre-SAS130 cases (logistic analysis 3), then again the results are very similar to run 1 treated as a benchmark. The SAS600 binary dominates, in

[28] However, since the majority of property companies are processed using the service sector model, some collinearity may be present in the logit analysis (the Pearsonian product moment correlation coefficient between the two binary variables is 0.34, significant at better than the 0.1% level).

this case again significant at better than the 0.1% level. These strong results confirm that the subsequent introduction of SAS130 is not responsible for the effects attributed to SAS600 above.

Finally, in the case of the very strict comparison of mandatory regimes pre-SAS600 and post-SAS600 but pre-SAS130, although the impact of the SAS600 dummy is less strong, it is still significant at better than the 10% level.

### 5.4 Summary

In this chapter we look at the impact of SAS600 on going concern disclosure rates. Considering the complete set of 1650 negative z-score cases for which data is available for the period with financial year ends 31.12.91 to 31.12.96, we find that the key determinant of the going concern disclosure rate, apart from the degree of financial distress of the firm as measured by its z-score and its prior audit history, is the audit reporting regime. Our evidence is consistent with this having a material impact on going concern disclosure rates, which cannot be explained by other factors such as degree of financial distress, state of the economy or sector.

On this basis we have powerful evidence leading us to reject null hypothesis $H_{01}$ that the SAS600 audit report style regime has had no significant impact on going concern disclosure rates. An important statistical finding is that the theoretical going concern disclosure rate is, *ceteris paribus*, more than doubled compared with the actual rate pre-SAS600 after SAS600 becomes mandatory. More stringent tests of the hypothesis in this chapter working with reduced data sets, omitting the SAS600 transition period, post-SAS130 cases and both of these combined, provide very similar results.

In the next chapter, we report on our logistic regression results exploring the incremental impact of SAS130 *The Going Concern Basis in Financial Statements* together with the Cadbury Guidance on going concern modification rates.

# Chapter 6: The incremental impact of SAS130 *The Going Concern Basis in Financial Statements* and the Cadbury Guidance

In Chapter 5 we explored the impact of SAS600 on the audit report disclosure of going concern uncertainties, adopting a multivariate logistic regression formulation. We find that the standard was associated with significantly increased disclosure rates which could not be explained by such factors as degree of financial risk or state of the economy.

In Chapter 3 we argued the SAS130/Cadbury auditing and reporting regime should result in a further increase in the rate of GCMs and in sub-section 3.2.2 of that chapter we formulated the following null hypothesis:

$H_{02}$ *SAS130/Cadbury leads to no increase in audit report going concern disclosure rates.*

In this chapter we explicitly test this hypothesis using the logistic regression model set out in sub-section 3.3.1 of Chapter 3.

## 6.1 Determining the SAS130 implementation date

A key issue in the testing of the impact of any audit procedure standard is audit firm implementation date. SAS130 was issued in November 1994 with immediate adoption encouraged but not required until audits of financial statements for periods ending on or after June 30 1995. Nonetheless, it is possible that auditors may have already implemented new procedures following publication of the relevant SAS130 exposure drafts leading to problems with determining the actual implementation date for test purposes. Discussions with audit technical partners elicited that the SAS130 promulgation date would have been the most likely implementation date as the point at which best practice was definitively formulated. These views were confirmed by a detailed reading of auditor responses to both the May 1992 and December 1993 SAS130 exposure drafts.[29] It is clear that audit firms were uniformly opposed to extending the period of the 'foreseeable future' and also highly resistant to the introduction of more proactive audit procedures for cost and, crucially, liability reasons.[30]

As such, we can be reasonably confident that the appropriate SAS130 implementation date for our purposes is the date of publication of the standard in November 1994, proxied by audit reports of financial statements with period ends of 30th September 1994 and later. However, in the next subsection we also provide parallel statistical analyses to test for sensitivity of our results to alternative SAS130 implementation date assumptions.

## 6.2 The logistic regression runs

In total we conduct five alternative regression runs depending on the date SAS130 is assumed to be adopted and treatment of any potentially confounding impact of SAS600, as detailed in Table 6.1. Specifically, in our first three runs, which include all 1650 cases, we use respectively the date of publication of SAS130 in November 1994, the most likely scenario, the mandatory date of 30th June 1995 year ends and, finally, the date of publication of the first exposure draft in May 1992. In this way we cover alternative scenarios ranging from the earliest possible change in audit firm procedures to the latest possible adoption date of the Standard. In addition, our fourth run, comprising a 1388 case sub-sample, omits the SAS130 transition period, which we take as encompassing 30.9.94 to 29.6.95 year ends, with the former date again proxying for adoption of SAS130 on publication date. The final logit run assumes SAS130 adoption on publication but with the 537 pre-SAS600 cases omitted in order to remove any possible confounding effect from the introduction of this

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29 Access to the full sets of responses was provided to the authors by the Auditing Practices Board.

30 Audit firms were particularly concerned about the potential for litigation resulting from an increase in their own responsibilities without an offsetting increase in those laid on management prior to finalisation of the Cadbury corporate governance guidelines in November 1994 (Cadbury, 1994) Geiger and Raghunandan (2001) also highlight auditor concerns relating to litigation threats in the going concern reporting environment.

standard.[31] In formulations 1, 4 and 5, where SAS130 is treated as adopted on publication, the dummy variable of interest represents the joint impact of SAS130 and the Cadbury Guidance, as these were issued concurrently. In formulations 2 and 3, however, where SAS130 is treated as adopted on a date other than when published, we are able to include separate binary variables for SAS130 and Cadbury.

[31] We do not conduct a separate run reflecting the publication of the second exposure draft in December 1993 because of its close proximity to the mandatory implementation of SAS600 for 30th September 1993 and later year ends which would have made separating out the impact of these two events in any analysis highly problematic.

## Table 6.1 SAS130 Logit Analytical Schema

| | | Pre-SAS600 style | | Post-SAS600 style | | |
|---|---|---|---|---|---|---|
| Logit analysis | No. of cases | Pre-ED130 | Post-ED130 | Pre-SAS130 publication | SAS130 mandatory* | SAS130 transition* |
| 1. (All cases – SAS130) adopted on publication) | 1650 | Pre | Pre | Pre | Post | Post |
| 2. (All cases – SAS130 adopted when mandatory) | 1650 | Pre | Pre | Pre | Pre | Post |
| 3. (All cases – SAS130 adopted when May 1992 ED published) | 1650 | Pre | Post | Post | Post | Post |
| 4. (SAS130 transition period omitted) | 1388 | Pre | Pre | Pre | | Post |
| 5. (Post-SAS600) | 1113 | | | Pre | Post | Post |

* Periods for which Cadbury guidance applies.

Notes: The ‘pre’ and ‘post’ entries in the table indicate companies with audit reports for the respective period are included in the relevant regression. ‘Pre’ indicates that the case is treated as pre-SAS130, and ‘post’ as post-SAS130.

In formulations 1, 4 and 5, the relevant dummy variable represents the joint impact of SAS130 and the Cadbury guidance as these were issued concurrently.

## 6.3 Empirical results

Table 6.2 presents the results of the five logit regressions. Our main interest focuses on the significance of the binary variables representing SAS130 and Cadbury. These measure their impact on audit report going concern disclosures after taking into account other possible influences represented by the remaining independent variables.

Runs 1(our principal set of results), 2 and 3 in Table 6.2, covering all 1650 cases for which data is available, are effectively identical to run 1 in Table 5.2, but with the addition of independent variables representing SAS130 and Cadbury. In the first model these are represented by a single variable measuring their joint impact, whereas in runs 2 and 3 they are included separately. The same independent variables are significant as reported in Table 5.2, with the key determinants of audit qualification being SAS600, the z-score, the negative net working capital and profit/loss dummies, audit lag and prior year qualification and the same industry dummies. Most importantly, in no case is the SAS130 or Cadbury variable significant at anywhere remotely approaching conventional levels. In the case of SAS130 being adopted on publication (run 1), $p = .59$ for the joint SAS130/Cadbury variable. On this basis it is clear that introduction of SAS130 together with Cadbury had no incremental impact on the going concern disclosure rate. It is the audit report communication standard, SAS600, with associated variable significance level unchanged at better than 0.1%, which is the main institutional determinant of the increased disclosure of going concern uncertainties.

**Table 6.2 Logistic regression of going concern disclosure on SAS130, Cadbury, SAS600, company performance and economic indicator variables**

| | | **1 SAS130 adopted upon publication** | | **2 SAS130 adopted when mandatory** | | **3 SAS130 procedures adopted after May 1992 ED published** | | **4 SAS130 transition period cases omitted** | | **5 SAS130 adopted when published; pre-SAS600 cases omitted*** | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Predicted sign | Coefficient | Sig. of Wald Statistic | Coefficient | Sig. of Wald Statistic | Coefficient | Sig. of Wald Statistic | Coefficient | Sig. of Wald Statistic | Coefficient | Sig. of Wald Statistic |
| SAS600 | + | 1.43 | .000 | 1.42 | .000 | 1.43 | .000 | 1.39 | .000 | | |
| SAS130/CADB | + | 0.13 | .592 | | | | | 0.09 | .751 | 0.04 | .869 |
| SAS130 | + | | | -0.04 | .910 | -0.02 | .952 | | | | |
| CADB | + | | | -0.15 | .619 | 0.13 | .600 | | | | |
| Z | - | -0.10 | .001 | -0.10 | .001 | -0.10 | .001 | -0.11 | .000 | -0.09 | .008 |
| NETWORTH | - | -0.49 | .069 | -0.49 | .069 | -0.49 | .069 | -0.34 | .237 | -0.64 | .056 |
| NETWCAP | - | -0.58 | .012 | -0.58 | .012 | -0.58 | .012 | -0.71 | .005 | -0.57 | .034 |
| GEAR | + | 0.10 | .413 | 0.10 | .414 | 0.10 | .413 | 0.05 | .501 | -0.12 | .564 |
| DIV | - | -8.42 | .430 | -8.42 | .430 | -8.42 | .430 | -8.23 | .492 | -8.53 | .492 |
| PBIT | - | -0.52 | .037 | -0.53 | .037 | -0.53 | .037 | -0.56 | .040 | -0.59 | .037 |
| ASSETLOG | ? | 0.32 | .026 | 0.32 | .026 | 0.32 | .026 | 0.32 | .038 | 0.20 | .241 |
| AUDITLAG | + | 0.01 | .000 | 0.01 | .000 | 0.01 | .000 | 0.01 | .000 | 0.01 | .000 |
| $QUAL_{t-1}$ | - | -1.57 | .000 | -1.57 | .000 | -1.57 | .000 | -1.62 | .000 | -1.67 | .000 |
| BIG6 | ? | 0.23 | .297 | 0.23 | .298 | 0.23 | .296 | 0.18 | .453 | 0.13 | .621 |
| GDPFCAST | - | -0.41 | .029 | -0.41 | .047 | -0.41 | .052 | -0.36 | .082 | -0.23 | .408 |
| CONSUMER | ? | -0.32 | .339 | -0.32 | .337 | -0.32 | .341 | -0.22 | .543 | -0.31 | .403 |
| PROPERTY | ? | -0.97 | .011 | -0.97 | .011 | -0.97 | .011 | -1.15 | .005 | -0.73 | .115 |
| RESOURCES | ? | -0.80 | .094 | -0.80 | .094 | -0.80 | .094 | -0.91 | .069 | -0.82 | .153 |
| SERVICE | ? | -0.42 | .205 | -0.42 | .207 | -0.42 | .205 | -0.41 | .259 | -0.39 | .310 |
| UTILITY | ? | -1.82 | .032 | -1.82 | .032 | -1.82 | .032 | -1.84 | .045 | -0.78 | .611 |
| MODELA | ? | -0.01 | .986 | -0.01 | .986 | -0.01 | .988 | 0.20 | .605 | -0.07 | .861 |
| MODELB | ? | 0.54 | .066 | 0.54 | .066 | 0.55 | .066 | 0.79 | .015 | 0.59 | .093 |
| CONSTANT | ? | 1.06 | .458 | 1.05 | .467 | 1.07 | .457 | 0.84 | .585 | 1.62 | .443 |
| No. of cases | | 1650 | | 1650 | | 1650 | | 1388 | | 1113 | |
| $\chi^2$ | | 554.47 | | 554.48 | | 554.47 | | 464.69 | | 387.75 | |
| $\chi^2_{sig.}$ | | .000 | | .000 | | .000 | | .000 | | .000 | |
| $R_L{}^2$ | | 43.7% | | 43.7% | | 43.7% | | 43.7% | | 42.6% | |

See Table 3.1 for variable definitions

The second logistic run explores whether treating the SAS130 mandatory date (i.e. for year-ends post 29.6.95) as its mandatory date is more appropriate. As can be seen the regression is effectively identical to logistic run 1, with the significance of the individual independent variables identical. The SAS130 binary variable, on this revised basis, is insignificant ($p = .91$) as is the separate Cadbury variable ($p = .62$).

Logit run 3 assumes that the SAS130 procedures would be adopted by audit firms at the earliest possible date, i.e. after publication of the initial exposure draft in May 1992. Once again, the results are effectively identical to the two previous runs with the SAS130 and Cadbury variables again insignificant ($p = .95$ and .60 respectively).

To take account of questions relating to the timing of the adoption of SAS130 by individual audit firms during its transition period, regression 4 is run with transition period cases omitted; SAS130 cases are included only once the standard is mandatory. Again the joint SAS130/Cadbury variable is insignificant ($p = .75$) and the other variables are similarly significant in line with runs 1 to 3.

The final run represents a very strong test of the value of the audit methodology standard SAS130 and Cadbury jointly and completely ignores the impact of SAS600. As in run 1, we assume that SAS130 is adopted when published. All pre-SAS600 cases are omitted, reducing our sample size by about one third. On this basis, again, the SAS130/Cadbury variable is insignificant ($p = .87$). Clearly SAS130/Cadbury is not associated in any way with enhanced audit report going concern uncertainty reporting.

In the light of the above results then, despite the very strong set of tests undertaken, we have no evidence whatsoever that SAS130/Cadbury has had any impact on audit disclosures in going concern situations and cannot reject our null hypothesis $H_{02}$.

## 6.4 Summary

In this chapter we explore the incremental impact of SAS130/Cadbury over and above the audit report communication standard SAS600. Our results demonstrate SAS130/Cadbury makes no contribution towards increasing audit going concern disclosures. Even in the most extreme situation, where we ignore pre-SAS600 cases, there is no discernible impact of the SAS130 auditing standard and the Cadbury Guidance on going concern reporting rates.

SAS130 and Cadbury introduced a range of new requirements, including an active, as opposed to a passive, audit approach in exploring for going concern issues, the extension of the period of the foreseeable future and the associated Cadbury requirement for directors to take formal responsibility for their own going concern disclosure. Our findings, however, are in direct contrast to our original expectations that there would be a measurable impact of this joint package.

It would appear that the key to enhanced audit report disclosures of going concern problems is changing the style of audit reports to make it easier for auditors to highlight such uncertainties, as SAS600 does. This has been far more effective than a requirement relating to internal, and therefore non-visible, changes to auditing procedures, an integral component of SAS130.

Chapter 3 discussed our original expectations that directors of firms with GCMs would themselves report such uncertainties as part of their Cadbury corporate governance disclosure requirements. This was reflected in the formulation of null hypothesis $H_{03}$. However, our unambiguous findings of no incremental impact on GCM rates of the SAS130/Cadbury package raises questions relating to directors' compliance with Cadbury in this area. In the next chapter we focus on this issue explicitly.

# Chapter 7: The reporting of going concern uncertainties by directors under Cadbury[32]

## 7.1 Introduction

In Chapter 6 we looked at whether the promulgation of the SAS130/Cadbury package had jointly an incremental impact on auditor behaviour, measured in terms of GCM rates. In contrast to the audit style standard SAS600, examined in Chapter 5, we found no evidence of any measurable change in audit report going concern uncertainty disclosure rates, contrary to our prior expectations.

On this basis the new SAS130 active audit approach, and lengthening of the period of the foreseeable future, did not lead to increased GCM disclosure rates. Equally, the Cadbury going concern directors' disclosure requirements, which should have been supportive of audit report going concern uncertainty reporting, clearly had no impact.

In an attempt to resolve this paradox, this chapter investigates directors' responses to the Cadbury Guidance and the information content of their going concern disclosures. Might we expect corporate governance to be enhanced in this area following the issuance of the Cadbury Guidance?

## 7.2 Cadbury guidance for directors' going concern disclosures

The *Guidance for Directors* (Cadbury Committee Working Group, 1994, para. 47) recommends that when directors have weighed up the results of their investigations into the going concern status of their business they can reach one of three conclusions. If the directors are confident of their business's existence in the foreseeable future then this is indicated by the basic statement (paragraph 49):

> 'After making enquiries, the directors have a reasonable expectation that the company has adequate resources to continue in operational existence for the foreseeable future. For this reason, they continue to adopt the going concern basis in preparing the accounts.'

[32] This chapter is contributed by Dr. Jinn-Yang Uang and is drawn from Chapter 6 of his Cranfield School of Management PhD thesis (Yang, 2001).

On the other hand, if there are factors identified which raise uncertainties about the company's ability to continue to trade in the foreseeable future but it is nonetheless appropriate for the statements to be drawn up on a going concern basis then the directors

> '... should explain the circumstances so as to identify the factors which give rise to the problems (including any external factors outside their control which may affect the outcome) and an explanation of how they intend to deal with the problem so as to resolve it.' (paragraph 50)

A good example of the latter Cadbury directors' statement is that for Rossmont Holdings Plc for the financial year ending 30th June 1996, provided in Appendix II.

These Cadbury disclosure requirements were simultaneously incorporated by the London Stock Exchange as part of its listing rules, again leading to the expectation of director reporting consistent with the Cadbury guidance and our null hypothesis.

## 7.3 Hypothesis

As discussed in Chapter 3, we would expect directors' going concern disclosures in companies with audit report GCMs to be consistent with their firm's financial position, the modified audit report itself and relevant footnotes to the accounts. We argued that, given the firm already has a going concern uncertainty modification, incremental costs of such associated disclosures by directors in conveying new adverse information are minimal. In addition, the Auditing Practices Board's (APB) requirement for auditors to review the directors' statement of compliance with Cadbury for consistency with their audit work (APB, 1995) would be a further reason motivating appropriate reporting by directors.

As such we established in sub-section 3.2.3 null hypothesis $H_{03}$:

> *Directors of companies with GCMs report in accordance with the Cadbury going concern disclosure requirements.*

## 7.4 Methodology

In exploring the consonance of directors' corporate governance disclosures in this area with the Cadbury Guidance we work with the benchmark provided by companies with a GCM audit report.

The crux of whether directors report in line with our null hypothesis or otherwise is based on analysis of whether their disclosures are classified according to paragraph 49 of the guidance, which we classify as an 'optimistic' statement because there are no uncertainties identified.

On the other hand, if there are such uncertainties about the company's ability to continue to trade in the foreseeable future then the directors are required (paragraph 50) to explain the circumstances and how they intend to resolve these matters. Such statements are classified as 'pessimistic' in the analysis below.[33]

Given the going concern uncertainties highlighted in the audit report, *a priori* we would expect directors to report in line with paragraph 50 rather than optimistic paragraph 49. We then seek to explain reporting patterns differing from our prior expectations in terms of z-score differences, risk levels and the published outcomes of auditor review of the Cadbury disclosures.

Binary high or low risk classification is subjectively assessed by reading the going concern notes to the accounts and weighting contrary information and mitigating factors. Although such judgement is somewhat subjective, reliability is driven by the familiarity of the researchers with the field.[34, 35]

## 7.5 Sample cases

This chapter focuses on all 89 cases of accounts with financial year-ends from June 1994 to December 1996 with going concern modifications (GCMs) in our original negative z-score population. There are 67 different firms in total, 49 of these have only one GCM during this period, 14 have two and four have GCMs in each of the three years.

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33 The third logical conclusion envisaged in paragraphs 52 to 54 where the going concern basis is not appropriate had no examples in our data set.

34 For example, we treat London & Metropolitan PLC (1996) as being low risk due to the statement: 'The group's bankers have agreed in principle to increase and extend their working capital facilities .... The Directors anticipate that signature will take place in the near future.' Similarly Tadpole Technology PLC (1995) is classified as high risk due to the disclosures: 'On the basis of current trading projections and assuming some of the planned property disposals will be achieved the directors consider sufficient funds and reserves will be available to meet redemptions as they fall due, although inherently there can be no certainty with regard to future results. ... It is also assumed the directors will be able to negotiate the continuance of the Group's bank overdraft facility.'

35 Risk classification of company cases was conducted by the author of this chapter and validated by the joint authors of this report.

36 In one case there was no directors' going concern disclosure.

## 7.6 Directors' going concern disclosures style results

To test hypothesis $H_{03}$, Table 7.1 summarises the manner in which the directors report on going concern status. There are as many as 22 out of our 89 cases (25%) with an optimistic disclosure, 43 with pessimistic opinions and 23 where, in essence, there is only reference to the note in the accounts.[36] On this basis, only just under half of the cases (48%) provide directors' disclosures which we would view as consistent with the *Guidance*, as all the 89 cases have GCMs. Appendix III provides an example of such typical information dissonance between the directors' and auditors' going concern messages taken from the Tadpole Technology Plc 30th September 1995 annual report and accounts.

**Table 7.1 Nature of directors' going concern disclosures**

| Style of disclosure | Number of cases | % of cases | Mean z-score | Nature of risk as disclosed in notes | |
|---|---|---|---|---|---|
| | | | | High risk | Low risk |
| 'Optimistic' style | 22 | 25 | -7.1 | 19 | 3 |
| 'Pessimistic' style | 43 | 48 | -8.4 | 42 | 1 |
| Other styles[1] | 24 | 27 | -9.2 | 23 | 1 |
| Total | 89 | 100 | -8.3 | 84 | 5 |

[1] Includes one case with no opinion.

Table 7.1 also provides mean z-scores for the three disclosure style categories. All cases have very negative scores which our earlier chapters, as well as Citron and Taffler (1992, 1999), show are a necessary condition for a going concern audit report uncertainty disclosure, and indicate a high risk of financial distress. There is, however, no significant difference between optimistic and pessimistic style z-scores ($t_{calc} = 1.03$, $t_{crit} = 2.03$ at $\alpha = 0.05$). Clearly our results cannot be explained by differences in z-scores *per se*.

To explore further the potential for variations in risk profiles across firms to explain the high level of 'optimistic' disclosures, the nature of the risk disclosed in the associated notes to the accounts is examined. This is classified on the basis of whether the degree of uncertainty is in process of being resolved – 'low risk', or whether such resolution is more speculative – 'high risk'.

Table 7.1 shows that in only three of the 22 optimistic cases can the going concern note be assessed as low risk. On this basis, in almost nine tenths of the optimistic directors' disclosures (19 out of 22), the importance of the adverse message appears to be being deliberately played down.

There are 24 cases (27%) where the directors' disclosure expresses no opinion on their company's going concern status and continued operational existence in the foreseeable future as required by the Cadbury Committee (1994) *Guidance* (paragraph 47). Here the directors restrict themselves either to stating that the accounts are drawn up on a going concern basis and refer to a note to the accounts (8 cases), or simply refer the reader to the relevant note without even specifying the basis on which the accounts are drawn up (15 cases), or provide no opinion whatsoever (1 case). All these 24 cases represent a clear violation of both the spirit and the letter of the new reporting regime in this area.

As less than half of our sample (43 cases, 48%) have the expected pessimistic style directors' GC disclosure we do not find evidence consistent with our null hypothesis $H_{03}$ that such directors' disclosures are consistent with the Cadbury requirements.

## 7.7 Consistency between directors' going concern statement and audit report

APB Bulletin 1995/1 *Disclosures Relating to Corporate Governance (Revised)* required auditors to state whether directors have provided the necessary going concern disclosures and whether these are '…not inconsistent with the information of which they are aware from their audit work in the financial statements…' (APB, 1995, para. 27).[37]

[37] The nature of the regulation has recently changed to a more standardised format (APB, 1999).

In an attempt to understand our results reflected by the lack of paragraph 50 directors' disclosures, Table 7.2 analyses the auditors' reviews of the directors' statement of compliance with Cadbury.

**Table 7.2 Auditors' reports on corporate governance matters analysed by style of publication and nature of directors' disclosure**

| | Nature of directors' disclosure | | | | |
|---|---|---|---|---|---|
| | **'Optimistic'** | **'Pessimistic'** | **Other** | **Total** | **%** |
| Audit review published | 17 | 31 | 16 | 64 | 72 |
| Audit review not published | 5 | 12 | 8 | 25 | 28 |
| | 22 | 43 | 24 | 89 | 100 |

In 64 of the 89 cases (72%) the findings of the audit review are published, either directly or indirectly (APB, 1995, para. 49), with an indication that the directors' statements are consistent with the audit findings. However, in as many as 25 cases (28%), we were unable to locate an auditors' report on corporate governance. This is despite the APB's strong recommendation that such reports be included in the annual report for the avoidance of ambiguities or misunderstandings (APB, 1995, para. 46). Clearly, absence of such a report must raise queries in the mind of the reader of the accounts about the conclusions of any audit review.

Further insight may be gained by breaking down the audit review disclosures by style of directors' statement. We would expect that in the case of pessimistic views the auditors' review would report consistency with their audit findings as all cases considered are GCMs. More interesting, however, are the 17 out of 22 optimistic cases where there is a *prima facie* expectation of inconsistency between such an optimistic directors' statement and the outcome of the audit. Are the auditors relying on the note reference in this case? Nonetheless, it is unlikely such an indirect method of disclosure was what Cadbury had in mind when formulating its code of governance.

The apparent reluctance of auditors to report on the clear inconsistency between the directors' Cadbury going concern disclosures and the modified audit report may help to explain our findings reported in Table 7.1 and our rejection of null hypothesis $H_{03}$.

## 7.8 Summary

One of the Cadbury Committee's major innovations is the requirement for the directors of all listed companies to report on their companies' going concern status. Whilst not actually adding anything to directors' well-established legal responsibilities, this requirement raises the profile of the going concern issue and, presumably, aims to ensure that directors have it in the forefront of their minds when drawing up their accounts.

This chapter examines the directors' Cadbury disclosures associated with 89 going concern modified audit reports from the start of the new disclosure regime, in November 1994, up until 31st December 1996 year ends. We find that in less than half of the cases do the directors adopt the pessimistic (paragraph 50) style of disclosure recommended by the Cadbury Committee Working Group *Guidance* which is *prima facie* appropriate in the case of companies with going concern modification (GCM) paragraphs in their audit report. In fact, in one quarter of cases, the directors make no direct statement at all on their companies' going concern position, a lack of communication which negates both the spirit and letter of Cadbury.

In the remaining one quarter of cases the directors adopt an optimistic disclosure style (paragraph 49) which is at odds with the economic realities. Of equal concern is the fact that in all 17 optimistic cases, where we were able to locate an auditors' report on corporate governance matters, the conclusion of the audit review is that the directors' disclosures are not inconsistent with the findings of the audit which led to a GCM.

These results demonstrate that, in many cases, the nature of the GCM audit report is directly at variance with the directors' Cadbury disclosures, which raises the question of latent, or perhaps more direct, conflict between the two parties. In many cases directors' disclosures are, at best, inadequate or, at worst, misleading, and audit reviews (where published) are not pointing out the apparent inconsistencies.

Chapter 6 showed that the Cadbury corporate governance disclosure requirement had no impact on GCM disclosure rates. The findings of this chapter suggest that the apparent reluctance of auditors to report on departures from Cadbury by directors may be a contributory factor.[38]

[38] SAS610 (Revised) *Communication of Audit Matters to Those Charged with Governance* (APB, 2001), published subsequent to our sample period, makes explicit the requirement on auditors to communicate their views on the impact of going concern uncertainties on the firm's financial reports frankly to company management (para. 41). We may speculate in the light of our findings whether this revised auditing standard will now lead to an improvement in the quality of directors' disclosures in this area.

# Chapter 8: Discussion and conclusions

This research report analyses the impact on audit going concern disclosure rates among UK listed non-financial companies of the two auditing standards, SAS600 *Auditors' Reports on Financial Statements* and SAS130 *The Going Concern Basis in Financial Statements*, together with the Cadbury requirement for directors to make going concern disclosures. This audit regime was introduced in response to low going concern disclosure rates among financially distressed and failing companies.

Our study relates to financially distressed companies with financial year-ends between 31.12.91 and 31.12.96 inclusive. We test the impact of this new audit regime by running a variety of regression models intended to explain going concern audit disclosure rates among our cases. We control for a wide variety of variables that are liable to impact on such disclosure rates including the state of the economy, and so are able to focus specifically on the impact of the introduction of SAS600 and SAS130/Cadbury respectively. We test for the robustness of our findings by running alternative versions of each model in order to take account of the different dates at which these auditing standards were adopted.

Our basic findings can be stated simply. We find a very significant increase in audit report going concern disclosure rates subsequent to the introduction of SAS600, the audit report style standard, but no incremental impact whatsoever following upon the introduction of SAS130 or the Cadbury guidance disclosure requirements placed on directors.

Turning first, then, to SAS600, it would appear that this standard, which laid down requirements for audit report format and content, has had a material impact on observed going concern disclosure rates. This impact can be understood from the perspectives of directors and auditors, both of whom are concerned about adverse disclosures such as going concern uncertainties. Directors have incentive problems about the disclosure of bad news and are averse to this taking place, whereas auditors will be concerned with having to make disclosures that are likely to promote conflict with client management. SAS600 addresses both of these issues. In the first place, a going concern uncertainty under SAS600 is no longer a qualification but merely an audit report modification. In this sense the news is less starkly bad and, as a result, directors should be less opposed to its publication. In addition, the new statement of directors' responsibilities regarding the financial statements highlights a greater sharing of responsibility between directors and auditors in this area and so should reduce the scope for conflict between the two parties.

For both these reasons, therefore, SAS600 has apparently been successful in promoting additional disclosure of bad news such as going concern uncertainties. Purists could argue that a new style going concern modification (GCM) is less explicit than the old style going concern qualification (GCQ) and that the expanded length of the SAS600 style audit report makes GCM paragraphs less conspicuous. Our findings indicate, however, that a toning down of the starkness of these bad news disclosures may actually assist in additional disclosure. In particular, this should not be problematical if we assume that the prime users of financial statements are sophisticated and not dependent on the clarity of disclosure but rather on the fact that it is made, whatever its form may be.

Turning to the impact of SAS130 and Cadbury, we find no incremental effect in terms of increased going concern uncertainty report rates in either case. While SAS130 certainly introduced enhanced audit procedures, such as have been described in Chapter 1 of this report, we can ask the question 'Can this going concern auditing standard be said to have improved the effectiveness of the going concern audit if it has not resulted in a concomitant increase in audit report GCM rates?'. One possible resolution of this question is that no further increase in such disclosure rates could be squeezed out of the system following on the improvements produced by SAS600. Alternatively, it could be argued that SAS130's improved audit procedures may have been introduced by different audit firms at different points in time and, as a result, its impact may not be readily measurable. However, both our investigations into the most likely implementation date and our various formulations of the logit regression model testing the impact of SAS130 have attempted to take this issue into account. At the end of the day, though, it should be argued, increased disclosure is the acid test of the impact of an auditing standard of this nature, and in this respect SAS130 has, indeed, been ineffective.

Nonetheless, it should, of course, be pointed out that our results cannot be extrapolated to indicate that SAS130 has had no positive impact on enhancing the quality of auditing going concern uncertainties. An important example of the contribution of SAS130, although not directly related to the objectives of this study, is its success in extending the period covered by the foreseeable future to at least one year beyond the date of approval of the accounts.[39]

Likewise, in the case of the Cadbury Committee *Guidance*, we similarly find no impact at all on going concern reporting rates. It could be questioned why it is that an audit report disclosure standard such as SAS600 has been effective in achieving increased going concern disclosure rates, whereas the Cadbury disclosure requirement placed on directors appears to have been unsuccessful. We would argue that directors have incentive problems with the disclosure of bad news. The Cadbury disclosure requirement is, in effect, a free form of disclosure, with directors able to choose between optimistic or pessimistic disclosure styles leading to potentially misleading signals. Audit reviews, when published, fail to point these out. It would appear, due to weak enforcement, Cadbury has 'failed to deliver' the directors, at least in the going concern area, so it has not been effective in providing this bolster to auditors in this contentious disclosure arena.

As a result, our SAS600 and our Cadbury disclosure conclusions do not, in effect, contradict one another. The SAS600 disclosure requirements are clear and standard and, to some extent, help both parties, directors and auditors. In contrast, the Cadbury disclosure requirements are open to interpretation and do not have the strength to support additional audit disclosures.

In conclusion, therefore, we can say that SAS600, the audit report style standard, has led to a significant increase in audit going concern uncertainty disclosures, whereas SAS130, the going concern auditing standard, and the Cadbury guidance for directors have had no incremental impact.

Audit standard setters can enhance the value of the audit by improving both audit procedures and the manner in which audit findings are reported. Our report demonstrates the importance that facilitating auditor disclosures can have, particularly in contentious situations. However, as our results relating to Cadbury show, it is not enough merely to require enhanced disclosures, but these need to be monitored carefully to have any value.

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[39] In only 4 of the 89 cases (4.5%) analysed in Chapter 7 did the respective auditors disclose this period to be of less than one year.

This report explicitly measures the success of the current UK going concern auditing regime in terms of whether or not this has led to an increase in the rate of reporting of going concern uncertainty disclosures. Further work can usefully focus on more qualitative areas of analysis such as exploring how the going concern auditing and reporting standards have actually impacted on firm procedures in practice and any potential deficiencies in these standards.

## APPENDIX I

### Rossmont Plc Going Concern Modified Audit Report for Financial Year Ending 30th June 1996

TO THE MEMBERS OF ROSSMONT PLC
We have audited the accounts, which have been prepared under the historical cost convention and on the basis of the accounting policies set out later. We have also examined the amounts disclosed relating to the emoluments, share options and long term incentive scheme interests of the directors which form part of the report to shareholders by the Remuneration Committee shown earlier.

RESPECTIVE RESPONSIBILITIES OF DIRECTORS AND AUDITORS
As described earlier the company's directors are responsible for the preparation of the accounts. It is our responsibility to form an independent opinion, based on our audit, on those accounts and to report our opinion to you.

BASIS OF OPINION
We conducted our audit in accordance with Auditing Standards issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the accounts. It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the accounts, and of whether the accounting policies are appropriate to the Group's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the accounts are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the accounts.

GOING CONCERN
In forming our opinion, we have considered the adequacy of the disclosures made in the accounts relating to the outcome of the negotiations with the Bank of Scotland for finance. The Group has not yet m*et al*l the conditions required for the release of the remaining £400,000 of the term loan facility described in note 19 and the Group will require further cash resources for working capital and future development. The accounts have been prepared on a going concern basis which assumes additional finance is available and do not include any adjustments which may be necessary if such finance is not made available. Details of the circumstances relating to this fundamental uncertainty are described in note 1. Our opinion is not qualified in this respect.

OPINION
In our opinion the accounts give a true and fair view of the state of affairs of the company and of the Group as at 30 June 1996 and of the loss of the Group for the year then ended and have been properly prepared in accordance with the Companies Act 1985.

Ernst & Young
Chartered Accountants
Registered Auditor
Southampton

7 January 1997

## APPENDIX II

### Rossmont Plc Directors’ Cadbury Going Concern Statement for Financial Year Ending 30th June 1996

The Group is in negotiations with its bankers and the controlling shareholder with a view to obtaining additional funds necessary to meet its future obligations. Based on the current state of these negotiations the directors have a reasonable expectation that the Group will have adequate resources to continue in operational existence for the foreseeable future. For this reason they continue to adopt the going concern basis for preparing accounts.

## APPENDIX III

**Information Dissonance between the Directors' and Auditors' Going Concern Messages: Tadpole Technology Plc Annual Report and Accounts for the Financial Year Ending 30th September 1995 (Extracts)**

*Audit Report Going Concern Explanatory Paragraph*

GOING CONCERN

In forming our opinion we have considered the adequacy of disclosures made in note 1 of the financial statements concerning the directors' plans for operating within their current and anticipated bank facilities. In view of the significance of the fact that the preparation of the financial statements on the going concern basis assumes the success of these plans, we consider that these disclosures should be drawn to your attention, but our opinion is not qualified in this respect.

*Directors' Going Concern Statement ( standard Cadbury paragraph 49 formulation)*

GOING CONCERN

After making enquiries, the directors have a reasonable expectation that the Company has adequate financial resources to continue in operational existence for the foreseeable future. For this reason they continue to adopt the going concern basis in preparing the accounts.

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