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The auditor's going concern decision and Types I and II errors: The Coase Theorem, transaction costs, bargaining power and attempts to mislead

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Abstract

It is shown that, in the absence of transaction costs and in line with the Coase Theorem, the going concern decision is efficient in the sense that bias arising from either Type I or II errors is not expected. However, when transaction costs in the form of legal costs, are introduced, bias is expected. The direction of the error depends upon the auditor's relative bargaining power. It is also shown that its relative bargaining power provides an incentive for the client company to mislead. Finally, certain empirical observations pertinent to this analysis are discussed together with the regulatory implications.

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1. Introduction

An investor needs to know whether a company in which he is interested is in immanent danger of failure. The easiest way to do this is to examine the audit report and whether in the auditor's opinion there is substantial doubt about the company's 'ability to continue as a going concern for a reasonable period of time' (SAS # 59). As the auditor is a trained professional with inside information into the commercial future of his client, the investor should be confident in the inferences he makes from the auditor's report. Normally, the report would be unqualified but contain a paragraph expressing such uncertainty. Also, if the auditor concludes that the financial statements inadequately indicate the company's inability to continue, the auditor should express either a qualified or adverse opinion in his report. A similar requirement and set of procedures exist in the UK. See ICAEW (1994). It will probably matter little to the investor as to what form such a conclusion may take in the auditor's report and for the remainder of this paper the term 'adverse report' will be used to cover them all.

The going concern decision has been the focus of a considerable amount of academic research over many years, primarily because it is an excellent example in which its independence may be tested. See Antle (1984), Asare (1990), Bartlett (1997), Chow and Rice (1982), Johnson et al. (1989), Jones (1996), Kida (1980), Knapp (1985), Krishnan and Stevens (1995), Lavin (1976), Lee and Stone (1995) and Pearson (1987) which are just a few paper to appear in academic journals. More recently, the decision may be seen to involve even greater stakes, given the concerns, particularly in the USA, about limited liability and the provision by audit firms of non-audit consultancy services (Davis et al., 1993).

Early research on the going concern decision focussed on audit quality involving (a) the possibility of incompetence (due to a lack of practical appreciation and understanding of the industry in which the client company operates) and (b) lack of independence (due to economic considerations, such as audit switching, affecting the audit firm that may arise from an adverse report). Research strongly supports the hypothesis that auditors are competent at making the going concern decision (the competence hypothesis). However sometimes, they do not issue an adverse report when they should, perhaps because of the fear of loss of the audit and the financial consequences to the audit firm (the independence hypothesis). For evidence to support both the competence and independence hypotheses see Mutchler (1984, 1985), Campisi and Trotman (1985), Menon and Schwartz (1987), Barnes and Huan (1993), Krishnan and Krishnan (1996), Matsumura et al. (1997) and Lennox (1999a) but for evidence to reject the independence hypothesis, see Louwers (1998). The relationship between the size of the auditing firm and independence has also been raised as well as the increased difficulty the auditor faces in maintaining his objectivity in the face of the potential loss of a large client paying substantial audit and consultancy fees, i.e. there is greater economic dependence (DeAngello, 1981c; McKeown et al.,

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