Available online at www.sciencedirect.com
ScienceDirect
ELSEVIER Journal of Accounting and Public Policy 25 (2006) 706–739
Journal of Accounting and Public Policy
www.elsevier.com/locate/jaccpubpol

Auditors' decision-making under going-concern uncertainties in low litigation-risk environments: Evidence from Hong Kong

Kevin C.K. Lam [a,*], Yaw M. Mensah [b]

[a] *School of Accountancy, Faculty of Business Administration, The Chinese University of Hong Kong, Shatin, NT, Hong Kong*
[b] *Department of Accounting and Information Systems, Rutgers Business School, Rutgers University, New Brunswick, NJ 08824, USA*

Abstract

This study examines the audit opinions issued by auditors in a low litigation-risk environment at a time of high economic uncertainty – that of Hong Kong in the period immediately after the Asian financial crisis of 1997. Empirical research using United States data has shown that, contrary to professional guidance which restricts the issue of "disclaimer of opinion" only to situations where existing uncertainties prevent the auditor from forming an opinion, auditors tend to use the "disclaimer" report (in the going concern context) to signal more extreme client firm's distress. In the high litigation-risk environment of the US, researchers have attributed this tendency to the idea that "disclaimer of opinion" reports are used by auditors to provide some protection against potential legal liability. The results of this study provide evidence that, even in the low litigation-risk environment of Hong Kong, auditors still use "disclaimer"

* Corresponding author. Tel.: +852 26 09 77 44; fax: +852 26 03 51 14.
E-mail addresses: kevinl@baf.msmail.cuhk.edu.hk (K.C.K. Lam), mensah@rbs.rutgers.edu (Y.M. Mensah).

0278-4254/$ - see front matter
doi:10.1016/j.jaccpubpol.2006.09.004

reports to signal more extreme client firm financial distress. Thus, the maintenance of a high litigation-risk environment does not appear to be a necessary pre-requisite for high quality audits.

Keywords: Audit opinions; Disclaimer of opinion; Financial condition; Litigation risk

1. Introduction

Although there are several theories relating to what economic role auditing plays, the type of audit opinion issued is presumed to further such a role.[1] Specifically, auditors' choice of modified opinions (e.g. explanatory notes, qualified with "except for", disclaimer and adverse opinion) can be important because they may convey different warning signals to users of the financial statements.[2] Thus, research on what factors influence auditors in arriving at their decision on the type of report (unqualified or some degree of modified opinion) and their predictive value in anticipating the ultimate outcomes are worthwhile.

Professional audit guidance in the United States on the appropriate audit reports to issue under going concern uncertainties are governed by Statement of Auditing Standards No. 58 (SAS No. 58) and Statement of Auditing Standards No. 59 (SAS No. 59). In countries following international auditing standards, the relevant ones are International Standards on Auditing No. 200 (ISA 200), and International Standards on Auditing No. 700 (ISA 700).[3] Under both the US and international auditing guidelines, the "disclaimer of opinion" is supposed to be issued by auditors only if, due to some inherent limitations of the audit environment, the auditors cannot form an opinion. According to Carmichael and Pany (1993), the Auditing Standards Committee allowed auditors to issue disclaimer of opinions because of the belief that auditors

[1] Two of these economic theories of the role of auditing are (1) the insurance role (Menon and Williams, 1994), and (2) the role of mitigating information asymmetry between management and users of the financial statements (Willenborg, 1999).

[2] The terms modified/qualified are used interchangeably here and so are qualification/modification. Although the qualified "subject to" opinion is not longer used in the United States, following the adoption of Statement of Auditing Standards No. 58 effective from 1989, it continues to be used elsewhere in other countries such as Great Britain and Hong Kong. Because this study is based on data from Hong Kong, its use has been retained in the paper.

[3] Hong Kong has moved to adopt the international auditing standards (or the predecessor United Kingdom standards) in most cases. For the purposes of this paper, the two standards of relevance in Hong Kong are Statement of Auditing Standards No. 600 (HK SAS No. 600): *Auditors Report on Financial Statements*, and Statement of Auditing Standards No. 130 (HK SAS 130) : *Going Concern*. These two standards follow ISA 700 and ISA 570 respectively.