Accounting, Organizations and Society 37 (2012) 322–341

Contents lists available at SciVerse ScienceDirect

Accounting, Organizations and Society

journal homepage: www.elsevier.com/locate/aos

The changing relationship between audit firm size and going concern reporting

Steven E. Kaplan [a], David D. Williams [b,*]

[a] W.P. Carey School of Business, Arizona State University, Tempe, AZ 85287, United States
[b] Fisher College of Business, Ohio State University, Columbus, OH 43210, United States

A B S T R A C T

As a result of gradual shifts in the market for audit services, we expect financially stressed public companies to be increasingly audited by regional firms, who, in turn, will be increasingly likely to issue going concern reports to their financially stressed public companies. Our expectations challenge the view that larger audit firms, in order to avoid exposure to litigation, report more conservatively. To address these issues, we examine the 22 years between 1989 and 2010, which we classify into four ERAs (e.g., 1989–1994, 1995–2001, 2002–2005, and 2006–2010). We initially document that over time, financially stressed public companies are shifting to regional audit firms, partly due to the actions of larger audit firms shedding these clients, which represent *ex-ante* conservatism. In contrast, audit firm reporting represents *ex-post* conservatism. We next show that over time, for their financially stressed public clients, regional audit firms are increasingly *more* likely to issue going concern reports, and BigN audit firms are increasingly *less* likely to issue going concern reports. We also show that in more recent ERAs, regional audit firms have been *more* likely than BigN and national audit firms to issue a going concern report to their financially stressed pubic clients. Overall, our evidence suggests that more recently, larger audit firms, relative to regional audit firms, acted more proactively to lessen their litigation risks through increasing centralization of client selection and acceptance processes. However, our evidence suggests that more recently, to lessen their litigation risks, regional audit firms, relative to BigN and national audit firms, acted more conservatively by issuing more going concern reports to their financially stressed public clients.

Introduction

Under Generally Accepted Auditing Standards (GAAS), audit firms have the responsibility to evaluate the going concern status of each of their clients and to include explanatory language in their report when they conclude that there is "substantial doubt" about a client's ability to continue as a going concern (GC) over the next year. This responsibility has been controversial, as well as consequential. Generally, managers of public companies prefer not to receive a GC report (Geiger & Rama, 2006; Mutchler, 1984), in part because equity markets react negatively when a GC report is issued (Blay & Geiger, 2001; Menon & Williams, 2010). However, issuing a GC report presumably lessens the litigation risks audit firms face from investors seeking to recover their losses (Carcello & Palmrose, 1994). Audit researchers have a longstanding interest in understanding the extent to which firm size moderates the strength of the relation between litigation risks and GC reporting (DeFond & Francis, 2005; Francis, 2004).

Audit researchers also have a longstanding interest in understanding the market for audit services and how it changes over time (Choi, Doogar, & Ganguly, 2004; Hogan & Martin, 2009; Jones & Raghunandan, 1998; Landsman, Nelson, & Rountree, 2009). Generally, the literature examines the extent to which the relative financial risks for the

* Corresponding author.
E-mail address: williams.77@osu.edu (D.D. Williams).

0361-3682/$ - see front matter © 2012 Elsevier Ltd. All rights reserved.
http://dx.doi.org/10.1016/j.aos.2012.05.002

portfolio of public clients differ by audit firm size and changes to these financial risks over time, but links to going concern reporting are limited (Francis & Krishnan, 2002). Thus, further research is warranted on how changes in the market for audit services impact GC reporting decisions among differentially sized audit firms.

The purpose of the current study is to provide longitudinal evidence on the changing relationship between audit firm size and auditor going concern reporting. Our longitudinal analysis examines 22 years divided into four ERAs. The years 1989–1994 represent the first ERA preceding passage of the Private Securities Litigation Reform Act (PSLRA). The years 1995–2001 represent the second ERA, following the PSLRA, but preceding the Sarbanes–Oxley (SOX) legislation and the demise of Arthur Andersen. The years 2002–2005 represent the third ERA, which includes the immediate years after SOX while audit firms and public companies were responding to these dramatic changes. The years 2006–2010 represent the fourth ERA, which includes the time when audit firms and public companies largely adjusted to temporary shocks in the audit environment occurring in 2002.

Our study focuses on three classes of audit firms (e.g., BigN, national, and regional[1]) across four different ERAs. Over time, we expect that financially stressed public companies will increasingly be audited by regional audit firms, who in turn will increasingly report more conservatively as demonstrated by a higher propensity to issue a GC audit report. In addition, among financially stressed public companies still audited by BigN audit firms, we expect a decreasing likelihood of receiving a going concern report over time (e.g., less conservative GC reporting). Overall, at some point, regional audit firms are expected to be more likely to issue a going concern report compared to larger audit firms. Our findings generally support these predictions.

We document that across the ERAs, financially stressed public companies are increasingly audited by regional audit firms. Specifically, our evidence indicates that regional firms only audited approximately 16% of financially stressed public companies in the first two ERAs, but over 30% in the last two ERAs. While a variety of factors are involved, this change reflects, in part, a decreasing willingness by larger audit firms to audit financially stressed public companies. The BigN audit firms began using more formal firm-wide screening practices in the early 1990s (Arthur Andersen et al., 1992) and over time, placed more emphasis on formal firm-wide screening as a means to avoid associating with "risky" audit clients (Bell, Bedard, Johnstone, & Smith, 2002; Winograd, Gerson, & Berlin, 2000). These screening practices focus, in part, on financial stress, which is generally observable to the audit firm and also associated with audit litigation (Latham & Linville, 1998).

We also document that for their financially stressed public companies, regional audit firms were more likely to issue a GC report in the latter ERAs, whereas BigN and national audit firms were increasingly less likely to issue a GC report. Krishnan, Raghunandan, and Joon (2007) refer to the use of audit reporting to control their firm's exposure to litigation risks as *ex-post* conservatism. Results are generally similar for an analysis of Type I accuracy (e.g., issuing a GC report to a client that becomes bankrupt in the subsequent year). In the case of regional firms, we believe this change reflects, in part, increases in regional firms' exposure to catastrophic litigation costs (Francis & Krishnan, 2002). We also believe the change among BigN firms reflects, in part, increases in BigN firm reliance on client screening as a mechanism to control their firm's exposure to litigation risks. Krishnan et al. (2007) refer to the use of client screening for this purpose as *ex-ante* conservatism.

Our study offers important contributions to the audit markets and to the GC reporting literatures. Specifically, the results of our study extend existing longitudinal auditing research on portfolios (e.g., Choi et al., 2004; Francis & Krishnan, 2002; Hogan & Martin, 2009; Landsman et al., 2009). Our evidence considers a long time horizon, more current data, and three categories of audit firms, which allows us to assess the effects of gradual changes in the audit environment on both the market for audit services and GC reporting. Our evidence is particularly important because it shows that in more recent time periods, BigN audit firms did not issue GC reports more conservatively than smaller audit firms for financially stressed public companies. Instead, in more recent time periods our evidence shows that for financially stressed public companies, regional firms issued GC reports more conservatively than did BigN and national audit firms.

The remainder of this paper is organized as follows. The next section discusses the auditing environment and develops the hypotheses. The third section describes the research methods and presents our results. The last section provides a discussion of our results.

The auditing environment and hypothesis development

Substantial changes have occurred in the auditing environment both before and during the years covered by our investigation (Asthana, Balsam, & Kim, 2009; Cooper & Robson, 2006; Kinney, 2005; Mills & Young, 1999; Preston, Cooper, Scarbrough, & Chilton, 1995; Wyatt, 2004; Zeff, 2003). Kinney (2005, p. 91) identifies three key events during the 1970s that "set the stage for the next 25 years of audit regulation." First, the Department of Justice and the Federal Trade Commission reached agreements with the AICPA to increase competiveness in the market for audit services. For example, restrictions on competitive bidding, uninvited solicitation of new clients, and advertising were eliminated and many additional changes occurred that potentially impacted the market for audit services and/or the conduct of audits. These changes were generally

[1] We refer to the largest international audit firms as the BigN across all time periods. During our four time periods, the largest auditing firms were the Big6 in ERA1, the Big5 in ERA2, and the Big4 in ERAs 3 and 4. National audit firms are defined as the next five largest audit firms after the BigN, based on client sales. For each of the four ERAs these five firms were BDO Seidman, Crowe Chizek, Grant Thornton, McGladrey & Pullen, and Moss Adams. Regional audit firms are defined as all audit firms that were not classified as BigN or national. There were 1744 different regional audit firms over the 22 years.