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Going-concern opinion decisions on bankrupt clients: Evidence of long-lasting auditor conservatism?

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A B S T R A C T

Geiger, Raghunandan, and Rama (2005) examine auditor going-concern decisions prior to client bankruptcy in the periods surrounding the enactment of the Sarbanes-Oxley Act (2002) at the start of this century and find evidence of improved conservatism. Feldmann and Read (2010) replicate and extend Geiger et al. (2005) and find that the proportion of going-concern opinions (GCOs) increases sharply in the post-SOX period (2002 – 2003) relative to the pre-SOX period (2000 – 2001). They show, however, that the improvement in conservatism is largely transitory and that the GCO ratio quickly declines over time, ultimately returning to its pre-SOX level by 2006. In this paper, we examine the prior audit opinions that auditors issued for a sample of 340 U.S. public companies that filed for bankruptcy during the years 2006–2015, a period that includes the recent Great Recession (hereafter, GR). Our analysis sheds light on whether the enormity of the GR resulted in a long-lasting change toward conservatism in auditor going-concern decisions on bankrupt clients. Controlling for confounding factors, we find that auditors were significantly more likely to issue GCOs to subsequently bankrupt clients following the onset of the GR. Finally, controlling for confounding factors, we find no significant change in the propensity of auditors to issue a GCO during the two post-GR recovery periods compared to going-concern decisions during the GR.

1. Introduction

U.S. legislators expressed concerns that companies often fail shortly after receiving a standard (unmodified) audit opinion, and criticized auditors for failing to warn the public of their client's impending financial collapse (cf., U.S. House of Representatives, 1985, 1990, 2002; U.S. Senate, 2002). Auditors, through going-concern modified audit opinions (hereafter, GCOs), publicly convey their assessment of whether substantial doubt exists about the client's ability to remain viable and continue as a going-concern. Kida (1980) and Mutchler (1984) suggest that auditors perceive a greater risk of economic loss when a client files for bankruptcy without having received a prior GCO. Prior research finds that auditors, in approximately 50% of the cases, make Type II errors (i.e., issuance of an unmodified audit opinion in the year preceding the filing of bankruptcy).[1]

Researchers who examine auditor going-concern decisions prior to client bankruptcy find that reporting conservatism strengthened in the wake of the Enron debacle. For example, Geiger, Raghunandan, and Rama (2005) report that U.S. bankruptcies that have audit opinions dated in the post-Sarbanes-Oxley (hereafter, SOX) period (2002–2003) were more likely to contain a GCO compared to opinions issued during the period between January 2000 and October 2001.[2] Later, Feldmann and Read (2010) examine audit opinions preceding the filing of bankruptcy over four time periods from 2000 to 2008 to assess whether the auditor conservatism reported by Geiger et al. (2005) persisted or was transitory. They find that while the proportion of GCOs increased sharply during the 2002–2003 period compared to the 2000–2001 period (as in Geiger et al., 2005), the proportion of GCOs declined during the periods that follow, ultimately returning to its pre-SOX levels.

The exogenous shock of the recent Great Recession (hereafter, GR), which resulted in a significant increase in public company

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[1] Please see Raghunandan and Rama (1995), Geiger et al. (2005), Feldmann and Read (2010), Carson et al. (2013).

[2] Geiger et al. (2005) find that during the audit opinion period 2002–2003 that firms filing bankruptcy were preceded by a GCO in 70% of the cases. In contrast, in the immediate preceding period (2000 – 2001), the rate was 40%. The findings of Geiger et al. (2005) toward more conservative auditor going-concern reporting in the immediate period following the Sarbanes-Oxley Act (hereafter, SOX) are consistent with the results reported by Fargher and Jiang (2008).

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bankruptcies, re-ignited interest in auditor reporting on financially distressed firms.[3] Carson et al. (2013) note that concerns about the accuracy of auditor going-concern reporting were especially salient during the GR. Geiger, Raghunandan, and Riccardi (2014) also stress that it is during periods of economic strife, similar to the GR, when investors look to auditors for guidance in evaluating the continuing viability of companies. Hence, in this paper, we examine the prior audit opinions for 340 public companies that filed for bankruptcy during the years 2006–2015.

Motivation for this study comes from the need to assess if the severity and duration of the GR resulted in a relatively long-lasting change toward conservatism in auditor reporting on bankrupt clients. Carson et al. (2013; p. 28) state that "whenever there is a sudden external shock, it is natural to think that there will be an immediate reaction; *a more important question, perhaps, is how long the effects last.* [Emphasis added]" In line with Carson et al.'s (2013) point of emphasis, we first examine whether auditor conservatism changed in response to the GR and then test whether auditors' response to GR persisted during the post-GR periods.

As a result of our empirical analysis, we find that the proportion of GCOs increased 21.2 percentage points moving from the pre-GR to the GR period. Consistently, the multivariate analysis, which controls for confounding factors, shows that auditors were significantly more conservative during the GR period (9/2008–12/2010) when compared to the pre-GR period (1/2006–8/2008). In contrast, the multivariate analysis shows no indication of a significant change in auditors' propensity to issue GCOs during the GR and post-GR periods.[4] These results support the conclusion that the increase in auditor conservatism associated with the onset of the GR was long-lasting in nature.

We also evaluate the changes in audit opinion decisions as a combination of changes in auditor reporting strategies and changes in client risk characteristics using the decomposition technique discussed in Francis and Krishnan (2002) and subsequently employed by Geiger et al. (2005) and Feldmann and Read (2010). As a result of this analysis, we find that the 21.2 percentage point increase in the average probability of receiving a GCO during the GR compared to the pre-GR period can be decomposed into a 13% increase related to auditor conservatism (61% of the total) and an 8.2% increase related to clientele risk (39% of the total). Of particular interest, as it relates to our findings of relatively long-lasting auditor conservatism, we find that the variation in the proportion of GCOs from the GR period to either of the two post-GR recovery periods (i.e., 2011–2013 and 2014–2015) is due largely to changes in clientele characteristics (less risky), as opposed to any significant change in the conservative reporting strategy adopted by auditors following the start of the GR. In other words, we find no evidence of a reduction in auditor conservatism in the aftermath of the GR. Hence, different from Feldmann and Read (2010) who find post-Enron conservative auditor reporting to be temporary, the GR appears to have resulted in a relatively long-lasting auditor conservatism. These findings should interest regulators worldwide who voiced concerns about auditor reporting on financially-distressed clientele (FRC, 2013; IAASB, 2009; IAASB, 2012; PCAOB 2009, 2011a, 2011b).

2. Background and hypotheses

GCOs can be used as a direct measure of audit quality given that the opinion is the sole responsibility of the auditor. An auditor's willingness to issue a GCO can indicate a high level of auditor independence (DeFond, Raghunandan, & Subramanyam, 2002). Geiger et al. (2005) note that in the immediate period following SOX, auditors were more likely to issue GCOs for firms that subsequently declared bankruptcy. Geiger et al. (2005) infer that auditors changed their reporting strategy to restore their reputation for high-quality auditing, reduce their litigation risk, and avoid government intervention given the unprecedented criticism of the profession by regulators, legislators, and the media during that period.[5]

As was the case with the accounting scandals (e.g., Enron) at the beginning of this century, the GR brought to the forefront the responsibility of auditors for assessing the continued viability of their audit clients. Geiger et al. (2014) suggest that this reporting responsibility becomes more problematic in periods of deep economic downturn, such as the GR, when companies are already facing severe financial distress. Hence, auditors may be hesitant to issue a GCO during such adverse operating environments to avoid exacerbating what is already for companies a very challenging time (Kida, 1980). Some observers of the accounting profession contend that more firms filed for bankruptcy without receiving a prior GCO following the onset of the GR compared to the prior period (e.g., Sikka, 2009; Woods, Humphrey, Dowd, & Liu, 2009).[6] In contrast, several studies offer empirical evidence that indicate otherwise. Geiger et al. (2014) using a sample of U.S. stressed companies find that the propensity of auditors to issue a GCO on a subsequently bankrupt client is significantly greater after the onset of the GR than in the immediate period preceding it. Also, while they do not assess auditor reporting on bankrupt companies, Xu, Jiang, Fargher, and Carson (2011) and Xu, Carson, Fargher, and Jiang (2013) find that auditors in Australia are more likely to issue a GCO during the GR period compared to the period just before it began. Hence, based on the evidence provided by these researchers, we expect to find an increase in auditor propensity to issue a GCO following the onset of the GR compared to the immediate prior period.[7] Thus, the first hypothesis examined in this study is:

H1. Bankrupt companies are more likely to have received a prior GCO following the start of the GR than in the immediately preceding period.

The findings from Geiger et al.'s (2014) analysis of the likelihood of auditors' issuing GCOs on bankrupt companies suggest increased auditor conservatism after the start of the GR. It is unclear, however, whether such reporting behavior is long-lasting or temporary. On the one hand, it is plausible that auditors became more hesitant to risk losing or alienating clients by issuing a GCO once the GR was over and economic conditions in the U.S. showed signs of improvement. On the other hand, it may be that the increased scrutiny auditors faced during the GR from the Public Company Accounting Oversight Board with its 2008 issuance of Staff Audit Practice Alert (SAPA) No. 3, Audit Considerations in the Current Economic Environment (PCAOB, 2008), resulted in heightened auditor conservatism over the long-term with regard to their propensity to issue a GCO to a soon-to-be bankrupt client. SAPA No. 3 noted that during the GR more companies than usual might be experiencing prolonged negative financial effects.

Hence, in response to the deepest economic recession since the Great Depression, auditors following the onset of the GR may have changed their reporting strategy and implemented a relatively long-

[3] Perhaps owing to the severity and scope of its economic hardships, the Associated Press in February 2010 began referring to the recent global economic meltdown as the 'Great Recession' (hereafter, GR).

[4] After the GR period comes to an end, the fraction of GCOs in our sample decline 10.78 to 15.02% depending on different post-GR period definitions. We find, however, that this decrease is largely due to confounding factors. The multivariate analysis, which controls for confounding factors, shows that auditors maintained their heightened conservatism during the entire post-GR period (1/2011–12/2015).

[5] Although SOX was enacted on July 30, 2002, Geiger et al. (2005) report that the media and congressional spotlight of the auditing profession was almost entirely unfavorable starting in late 2001 resulting in a changed (more conservative) environment of auditing in the U.S.

[6] In addition, regulators in the U.S. were critical of auditors for their apparent failure, in several cases, of not issuing a GCO during the GR to audit clients prior to their filing for bankruptcy (PCAOB, 2009, 2011a, 2011b).

[7] Although Geiger et al. (2014) find that the propensity of auditors to issue a GCO prior to bankruptcy significantly increased after the onset of the GR, we replicate H1 in this paper given differences in our respective sample sizes (discussed in the next section).