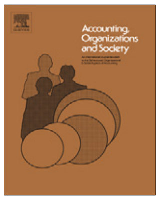
Accounting, Organizations and Society 37 (2012) 223–241

Contents lists available at SciVerse ScienceDirect

Accounting, Organizations and Society

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



The effect of strategic and operating turnaround initiatives on audit reporting for distressed companies

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A B S T R A C T

Empirical research on the effect of turnaround initiatives on audit reporting is scant. This paper addresses this gap by examining audit reporting for distressed companies and its association with a broad array of strategic and operating turnaround initiatives. In particular, we study the association between business risk information and going-concern decisions for distressed clients. Using a sample of distressed firms in the US manufacturing industry, we find that *both* short-term cash flow potential as well as strategic growth and hence long-term cash flow potential are necessary for strategic turnaround initiatives to have a mitigating impact on the auditor's going-concern decision. Strategic turnaround initiatives for which only one of these two conditions holds and operating turnaround initiatives appear to function as going-concern risk factors as they are associated with a higher likelihood that a going-concern opinion will be issued. We also find that specialist and non-specialist auditors assess the mitigating potential of some but not all turnaround initiatives differently. Overall, our results suggest that auditors' strategic risk assessment (typically done in a business risk auditing context) is associated with the outcome of the audit process (the opinion).

Introduction

Audit reporting of distressed companies is more relevant than ever as management and auditors face the consequences of the global financial crisis and economic downturn. In the midst of this economic turmoil, standard setters are considering revisions to the auditing standard on the auditor's evaluation of a company's ability to continue as a going concern (i.e. SAS No. 59). At the November 2011 Standing Advisory Group (SAG) Meeting,[1] the PCAOB discussed the nature of conditions or events that should be considered in determining substantial doubt and whether the going-concern assessment should be limited to the ensuing fiscal year. This paper examines two issues related to the current debate about the time horizon and scope of information considered in going-concern decision-making: In particular, we ask: (1) do auditors take into account management plans and strategic actions to overcome financial difficulties, and (2) do auditors only assess short-term viability, or do they adopt a long-term view when making a going-concern decision. To that purpose we investigate whether and how a broad array of strategic and operating turnaround initiatives taken by management of financially distressed firms affect the auditor's going-concern decision. In addition, we examine whether auditor industry specialization amplifies the extent to which auditors rely on strategic or operating turnaround initiatives in this context. We argue that their knowledge of industry best practices will allow specialist auditors to evaluate the adequacy and appropriateness of proposed management turnaround initiatives better, which in turn leads to an increased use of this type of information in going-concern decision-making.

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[1] Available from <http://pcaobus.org/News/Events/Documents/11092011_SAGMeeting/Going_Concern_PCAOB_Slides.pdf>.

0361-3682/$ - see front matter
http://dx.doi.org/10.1016/j.aos.2012.03.001

It is well documented in the literature that auditors make going-concern decisions based on reported financial results and compliance with financial obligations (e.g., Bell & Tabor, 1991; Chen & Church, 1992; Mutchler, 1985). However, the importance of non-financial information is also emphasized in the auditing standards – besides negative financial trends or other indications of possible financial difficulties (for example, default on loan agreements), SAS No. 59 defines certain (non-financial) internal and external matters as conditions or events that may raise concerns about the entity's ability to continue as a going-concern. As a result, SAS No. 59 requires auditors to also consider management plans to *mitigate* the effects of such adverse conditions or events when assessing a client's ability to continue as a going-concern.

The increased relevance of strategic considerations in the audit decision-making context is attributable in part to changes in auditing scope and methodology that took place in (a number of) large accounting firms in the second half of the 1990s (e.g., Bell, Marrs, Solomon, & Thomas, 1997; Bell, Peecher, & Solomon, 2005; Curtis & Turley, 2007; Knechel, 2007; Peecher, Schwartz, & Solomon, 2007; Power, 2007; Robson, Humphrey, Khalifa, & Jones, 2007). Whereas traditional auditing approaches employ a bottom-up focus that directs attention to account balances, transaction classes, and properties of the client's accounting system, business risk auditing takes a top-down perspective of the client's business and industry, which entails analyzing the client's strategic position. A general evolution towards business risk auditing is further reflected in some of the new International Audit Risk Standards, such as ISA 315.

However, while the importance of the client's business and strategy is recognized by auditing practitioners, research about the effect of strategic plans on the likelihood of going-concern opinions is scant.[2] In this paper we address this gap by providing the first comprehensive study to our knowledge on the association between business risk information and going-concern decisions for distressed clients. In particular, we investigate the impact of a broad set of strategic and operating turnaround initiatives on an auditor's going-concern decision and also examine whether this information is used more extensively (or differently) by industry specialists, compared to non-specialists. More specifically, drawing on a rich body of evidence from the strategy literature,[3] we begin by defining a comprehensive set of turnaround initiatives. We initially distinguish between two types of management turnaround initiatives: operating turnaround initiatives such as cost-cutting and asset disposal that aim *only* at short-term improvement in financial performance, and strategic growth initiatives such as strategic alliances and acquisitions that aim at long-term improvement of financial performance. As going-concern decision-making involves the assessment of the likelihood of company survival *within the next 12 months*, an auditor is interested in the short-term financial impact of management turnaround initiatives. Therefore, we further sub-divide the strategic growth initiatives into two categories: strategic growth initiatives that have short-term positive cash flow potential beyond their long-term positive cash flow potential (such as cooperative agreements), and strategic growth initiatives that only have long-term positive cash flow potential (such as innovation and expansion strategies). Next, for each type of turnaround initiative that we consider, we follow the literature on successful company turnaround and test the association between the incidence of the initiative and the likelihood of receiving a going-concern opinion. We then test whether specialist and non-specialist auditors use information with respect to company turnaround initiatives to the same extent in light of a going-concern reporting decision.

Like other going-concern studies using non-financial information, we rely on information disclosed in the management discussion and analysis (MD&A[4]) section of a firm's 10-K, plus any related information provided in the remainder of the 10-K (Behn et al., 2001; Geiger & Rama, 2003). We find that strategic growth initiatives that have short-term in addition to long-term positive cash flow potential are negatively associated with the likelihood that a going-concern opinion is issued. Thus, initiatives that belong to this class appear to be perceived by auditors as distress-mitigating. In contrast, strategic growth initiatives such as acquisitions that have long-term but not short-term positive cash flow potential are positively associated with the issuance of a going-concern opinion. Thus, initiatives of this type are perceived to be an additional going-concern risk factor. A similar result holds for cost reduction strategies which are operating turnaround initiatives that do not involve changes in the organization's strategy. This implies that initiatives of this type also send a negative signal to the auditor about a distressed company's viability. Finally, we find that specialist and non-specialist auditors assess operating turnaround initiatives differently in light of a going-concern decision. In particular, we find that specialist auditors are more inclined to issue a going-concern opinion when their client implements operating turnaround initiatives, whereas this does not hold for non-specialists.

The remainder of this paper is organized as follows. In the next section we develop our hypotheses. Section 3 discusses the going-concern opinion model that is used in our analyses. Next, in Section 4 we provide an overview of our sample selection procedure and data collection approach. Section 5 presents our results. Finally, we conclude in Section 6.

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[2] In one paper that looks at the factors influencing going-concern opinions, Behn, Kaplan, and Krumwiede (2001) find evidence of a relationship between the likelihood of going-concern opinions and a company's ability to obtain new financing (through equity issues and additional borrowing). In another paper somewhat more closely related to ours, Mutchler and Hopwood (1997) document the impact of contrary and mitigation factors in publicly available disclosures, but do not consider strategic turnaround actions.

[3] See, for example, Barker and Duhaime (1997), Barker and Mone (1994), Bruton, Ahlstrom, and Wan (2003), Hofer (1980), and Sudarsanam and Lai (2001).

[4] The SEC requires that firms discuss in the MD&A the results of operations, liquidity, capital resources and any known trends, demands, commitments, uncertainties and events that may affect these (SEC, 1980). Registrants must also include descriptions and amounts of matters that would have an impact on future operations.