

Emerging Markets Queries in Finance and Business

New audit reporting challenges: auditing the going concern basis of accounting

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Abstract

For decades, the audit profession has been overwhelmed with a series of polemics, which led to the need of essential reform and developments. This study aims to investigate what is the users' opinion about IAASBs new audit reporting proposals regarding the revision of the ISA570 – Going Concern. This proposal comes after several scandals related to audit reporting on going concern have decreased user confidence in the audit profession. We achieve this objective by examining comment letters sent to the IAASB by respondents from the EU. We have found that most of the replies either have concerns with IAASBs proposals or are completely disagreeing with them, as they would bring no value to users and do nothing to reduce the expectation gap. Still, most users salute the revision process and urge the IAASB to closely work with other bodies for this matter. We conclude that the proposals from Exposure Draft will most likely have a positive effect on audit reporting, after their final revision.

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1. Introduction

Triggered by the financial crisis and by financial scandals of the last decade, the European Commission has launched a broad consultation process among EU country members regarding audit reform. This includes issues relating to the role of the financial audit, the independence of auditors, and the transparency of provided

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information in the audit report and also concerns about audit compliance with the transparency principle, in the context on corporate governance. The transition to efficient corporate governance had a direct effect on audit reporting and on audit market concentration upon Big Four auditors.

Thus, a challenge in this research area is a better distinction between the roles of management, the Audit Committee and the auditor in the discussion and the disclosure of uncertainties regarding business continuity, or, the going concern assumption (or basis of accounting). Related to this, the Financial Accounting Standards Board (FASB) proposed that the management report should include details about going concern (FASB, 2008, 2011), and in more recent activities, the FASB focused their attention on the importance of changes regarding the going concern basis of accounting (FASB, 2012). At international level, the International Accounting Standards Board (IASB) is currently involved in a project with the objective of clarifying the disclosure requirements about the assessment of going concern in IAS 1. An exposure draft has been published in March 2014. Other new proposals include a revision of the audit report, in order to increase the level of disclosure provided by the auditors. This includes a specific statement on whether the use of the going concern basis of accounting, by the management, is appropriate (IAASB, 2012, 2014). Recent EU legislation like Regulation No. 537/2014 and Directive 2014/56/EU do not necessarily approach the going concern audit reporting topic, but the European Commission constantly analyses audit reforms and works with the IAASB to reform audit policies.

The International Audit and Assurance Standards Board (IAASB), the regulating body of International Standards for Audit (ISAs) has been involved, in the last years, in a process of clarification of auditing standards, by focusing on audit reporting and on audit quality. The 2009's "Clarity Project" was launched with the aim of improving clarity and quality in all ISAs (IAASB, 2009). The reform continued in 2011 with the consultation paper "Enhancing the Value of Auditor Reporting: Exploring Options for Change" and in 2012 the IAASB released the invitation to comment "Improving the Auditor's Report". The most recent work of the regulating body has been the 2013 invitation to comment with the title "Proposed New and Revised International Standards on Auditing. An invitation to comment".

This research represents a logical insight in addressing going concern audit reporting and the implications of reforms in the audit filed on this particular aspect. We plan of achieving this, by examining comment letters (user responses) that the IAASB has received for its 2013 *Proposed New and Revised International Standards on Auditing. An invitation to comment*. We have only selected responses coming from organisations, bodies or individuals from within the EU because for this study we want to focus our attention on the perceptions regarding audit reforms in the EU. Our working method can be described as both a quantitative and qualitative study, because we will analyse responses through a grading system, but also thoroughly study the content of each comment letter. After that, we will interpret and discuss the results.

2. Audit and the going concern basis of accounting

One of the basic requirements of an efficient market is an efficient audit process. In achieving an efficient audit, one essential condition is to obtain a true and fair view of the financial position and performance of the entity. For the financial statements to present fairly, in all material aspects the financial position and performance, a methodological approach structured in successive, well-defined stages is necessary. Another condition is to take into account any changes that have occurred to these assertions during the financial year, but also consider the impact of these changes to the entity's future. At this stage, the auditor analyses the appropriateness of the entity's use of the going concern basis of accounting (Martens et al., 2008).

In July 2013, the IAASB released a new exposure draft on auditor reporting which sought views from stakeholders (investors, analysts and other users of audited financial statements) with regards to the proposals of enhancement, revision and improvement. At the previous Invitation to Comment (ITC) in 2012, one main

conclusion was the fact that users need more relevant information within the audit report, thus the current exposure draft seeks to bring amendments to this area.

Inappropriate testing of the appropriateness of the entity's applicability of the going concern basis of accounting can lead to a low quality audit. It is clear that a qualified audit report caused by going concern issues is a signal for investors that either the management of the company is unable to keep the company profitable, or that they have attempted to present an over-favourable view of the company's performance and/or position. Thus, there is clear relation between going concern audit reporting and audit quality. A series of authors have analysed how audit quality has evolved starting with the 19th century, when many countries have improved audit quality by new regulations regarding auditor independence and public surveillance (Fülöp, 2012). All these alterations have brought better results in refining audit quality (Baker et al., 2010). Some authors like Brian et al. (2007) and Lennox (1999) consider audit quality can be measured by reducing risks and by the auditors' reputation, while others like Lowensohn et al. (2007), Watkins et al., (2004), Herrbach (2001) and Knechel (2000) think audit quality can be determined through auditor competence and responsibility. In addition, qualified reports cause share prices to fall, reducing managerial utility if managers own shares or if their compensation is directly related to market value (Firth, 1978; Banks and Kinney, 1982; Fleak and Wilson, 1994; Chen and Church, 1996; Jones, 1996).

Another aspect studied by a number of researchers is the ability of an entity to continue as a going concern, and the ability to predict failures and financial collapses (McKeown et al. 1991, Hopwood et al., 1994; Gaeremynck and Willekens, 2003; Vanstraelen, 2003, Carey et al., 2008; Blay et al., 2011; Goh et al., 2013; Feldmann and Read, 2013; Amin et al. 2014). The authors consider that auditors have become a more important "piece of the puzzle" in the going concern basis of accounting applicability, because of major financial scandals in which auditors were at the center of attention. These scandals have had an enormous effect on investor confidence, causing a decrease in the level of trust relating to auditor opinion and their actual assurance in detecting fraud and error. Conversely, issuing an audit report with a qualified opinion further increases the client's financial difficulties since the likelihood of bankruptcy (but not voluntary liquidation) increases for companies receiving such an audit opinion.

More recently, Kaplan and Williams (2013) find the issuance of a going-concern opinion is an insignificant predictor of lawsuits in a single equation model. However, the relation becomes significantly negative after they control for endogeneity by replacing the observed going-concern variable with an instrumented going-concern variable.

The IAASB, though the 2013 Exposure Draft has started a process of revision of audit standards, including the ISA 570 – Going Concern, with the purpose of clarification of regulations and to provide more accurate and insightful information via the audit report – information relevant to the public interest, of course. The ISA 570 – Going Concern is the auditing standard which deals with the auditor's responsibility regarding the audit of financial statements relating to going concern. The new and revised standard proposes several changes, which we plan on presenting in the following paragraphs.

The wording of the questions from the invitation to comment, regarding the Going Concern audit reporting is listed below (IAASB, 2013: ITC):

- Question 9: Do respondents agree with the statements included in the illustrative auditor's reports relating to:
 - The appropriateness of management's use of the going concern basis of accounting in the preparation of the entity's financial statements?
 - Whether the auditor has identified a material uncertainty that may cast significant doubt on the entity's ability to concern, including when such an uncertainty has been identified?
- Question 10: What are respondents' views as to whether an explicit statement that neither management nor the auditor can guarantee the entity's ability to continue as a going concern should be required in the auditor's report whether or not a material uncertainty has been identified?

Other questions present in the ITC are not taken into consideration within this study because they refer to other aspects covered by the IAASB in the exposure draft, such as: the key audit matters concept, transparency and compliance with independence and other ethical requirements.

3. Research Methodology

The research approach for this study is content analysis, previously used in several other studies for analyzing comment letters to exposure draft published by the IASB or FASB (Yen et al., 2007; Tiron & Muller, 2009; Holder et al., 2013). The data used for the analysis comes from the answers to the 2 selected questions regarding Going Concern basis of accounting audit reporting, addressed by the IAASB within the Exposure Draft. The Exposure Draft, published in July 2013, received a total number of 138 comment letters until November 2013, most of them coming from English-speaking countries, like the U.S., Canada and the U.K. These answers were published by the IAASB on their website, at the project webpage. A first step was the collection of data in order to construct a database of all the responses. As stated before, we have only selected the responses from comment letters issued by organizations, regulating bodies or individuals from within the EU, because our focus is to seek the opinion of EU users regarding audit changes. Thus, a total of 47 replies have been selected in our sample. Because the collected data features an unstructured character, given the fact that some of the boards' questions required an open answer, the next step has been to inspect each comment letter, through a qualitative analysis of the text. Not all the respondents gave a specific answer to each question (or to all questions), and some have limited themselves only to the expression of a general opinion regarding the work plan of the Board. Thus, we have recoded the answers, as follows:

- Y (Yes), if the comment letter provides an answer to the question, and generally agrees with what is proposed;
- Y* (Yes, with concerns), if the comment letter answers a question, and although it agrees with what is proposed, several concerns are stated;
- N (No), if the answer in the comment letter is not in agreement with what is proposed, providing an altogether different vision; these answers offer a detailed reason for this matter and suggestions for improvement;
- N/A (Not applicable), if the comment letter does not provide an answer to the question.

Subsequently, we have analyzed the answers from both a quantitative and qualitative approach. For the quantitative part of our study, we focus on a general analysis of the answers within the comment letters, in the whole sample; for the qualitative part, we use a more analytical approach by focusing on replies and comments given by regulating bodies, Big Four audit firms and other noteworthy answers.

4. Responses analysis – quantitative approach

Considering our proposed objectives, the methodology and the importance of our study, in the following section we will expose the results of our study and provide insights regarding our findings concerning going concern audit reporting.

As stated before, only answers provided to Questions 9 and 10 from the published 2013 Exposure Draft were selected because only these enquiries are related to the audit reporting of Going Concern basis of accounting. Comment letters received by the IAASB from the European Union space were selected, cumulating to a number of 47 replies, either from individuals, regulating bodies, national chambers of auditors or companies.

One first focus point is a general analysis of the sample. From the 47 received answers, 5 were sent by EU regulating bodies (Fédération des Experts Comptables Européens, the European Banking Authority, the European Audit Inspection Group, the European Court of Auditors and the European Securities and Markets

Auditory). The fact that these bodies are interested in the developments posted by the IAASB proves the interest of European counterparts in the audit legislation. What we would have wanted is a response from the European Commission as well. In the last period, the European Parliament has issued audit-reform related legislation, such as the April 2014 Regulation No. 537/2014 and Directive 2014/56/EU on statutory audit. While these regulations contain no reference to the newest developments pushed by the IAASB, we believe the input provided by the European Commission would be welcomed in the future, in the process of audit reform. Most comment letters (43%, or 20) were sent from individuals or companies from the United Kingdom; from the whole array of comment letters (world-wide) most were received from English-speaking countries, which is understandable, as the Exposure Draft and the included questions were issued only in English language. Amongst these replies we find three Big Four audit firms (*PricewaterhouseCoopers*, *KPMG* and *Ernst&Young*), but also smaller audit firms (*BDO International.*, *Grant Thornton* etc.) as well as relevant bodies for the accounting profession like the *Association of Chartered Certified Accountants (ACCA)* or the *Institute of Chartered Accountants in England and Wales (ICAEW)*.

In the following section, we will continue by presenting our findings regarding each specific question.

- Question 9: Do respondents agree with the statements included in the illustrative auditor’s reports relating to:
 - a) The appropriateness of management’s use of the going concern basis of accounting in the preparation of the entity’s financial statements?
 - b) Whether the auditor has identified a material uncertainty that may cast significant doubt on the entity’s ability to concern, including when such an uncertainty has been identified?

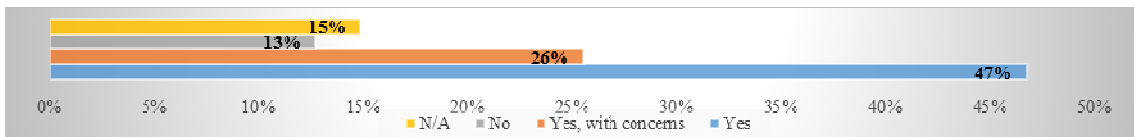


Fig. 1. Answer analysis for IAASB Question 9, a)

Fig. 1 contains an analysis of responses to part a) of Question 9, regarding the agreement with the IAASB’s views concerning the revised ISA570. The revised standard proposes a somewhat different approach than before, by focusing on the appropriateness of the management’s use of the going concern basis of accounting in preparation of the financial statement. As presented in the first part of this study, the new ISA570 proposes a new section of the audit report with the title “Going Concern” to better appeal the public’s interests and the intensified attention on going concern within the audit reform.

85% of all comment letters provided answers and feedback tot this question. 47% of the respondents agree with the IAASBs proposal to include a statement in the audit report regarding this particular issue. One general theme of the provided replies to this question is to acknowledge the IAASB’s efforts and to encourage future development, as other standard setter such as the IASB and FASB complete their projects addressing going concern. Thus, many have expressed their desire for further developments after other standard setters finish regulations on going concern.

Many replies are in agreement with the statement, but have several concerns regarding this matter (26%). We have noticed that all Big Four audit firms present in our sample fall into this category. *PwC*, for instance, support the new section, but their internal testing (by consulting with their clients) suggest that it is considered boilerplate and does not provide transparency. Others believe that there is an overlap in the statements of management and the auditor, which will bring problems of misinterpretation by users. *E&Y* also stresses this aspect, while suggesting users might find in hard to understand the use of specialised terminology. *KPMG*

considers IAASB should closely work with IASB to resolve issues regarding language issues (key terms), circumstances in which entities are required to undertake a going concern assessment, what disclosures are necessary etc. This is also the belief of the *ICAEW*, who believe the IAASB should wait for IASB/FASB developments in financial reporting regarding going concern.

13% of the replies are not in agreement with the proposals. The *FEE* believes the new section will confuse readers rather than inform them, with the following reasons: the section is too long, and readers are perceiving a higher degree of comfort than intended. Unlike the IAASB, they propose three situations: no going concern issues, potential going concern issues and clear going concern issues. Some considers that reporting on going concern should only be necessary when the issue is a Key Audit Matter, because that’s when it would bring real value to the users; if auditors will always report on going concern, even when the entity’s use of the going concern basis of accounting is appropriate, it would bring users a false sense of comfort.

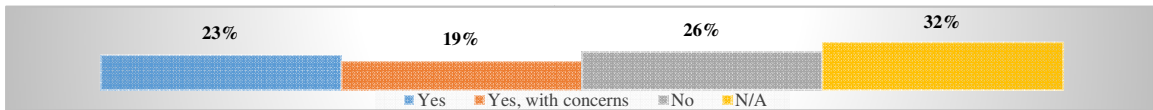


Fig. 2. Answer analysis for IAASB Question 9, b)

Fig. 2 contains an analysis of responses to part b) of Question 9 regarding the agreement with the statements relating to the auditor identification of a material uncertainty. For this question, only 68% of the comment letters provided an answer.

23% are in agreement with IAASBs statements. The *European Audit Inspection Group*, for instance, considers that the statement enhanced the focus of the auditor ongoing concern issues, which is a positive incentive. The *European Securities and Markets Authority* ponders on the additional information regarding the auditor assessment, which should help reduce the AEG and information asymmetry between the users and management. While the *FEE* agrees with IAASBs statement, is considers that the regulating body should wait for IASB projects regarding going concern to wrap up before pushing a final revised ISA 570.

On the other hand, 19% of the comment issuers have concerns regarding this statement. Most of these concerns come from questions regarding the interaction between mandatory statements, Key Audit Matters, Emphasis of Matters paragraphs and material uncertainties. Even the IAASB recognises that any material uncertainty is, in fact, a Key Audit Matter, but should be presented in the Going Concern section. Big Four audit firms (*KPMG*, *PwC* and *E&Y*) but also the *ICAEW* stress the confusion on how KAMs and material uncertainties work together. Others argue that the phrasing should be simplified because some of the situations might be confusing to users (appropriate use of going concern, but material uncertainties were discovered).

26% of the replies disagree with IAASB’s proposals. Starting with problems regarding the too specialised language (*Association of International Accountants UK*), like material uncertainties, many believe that the new proposals do no add any value that investors actually seek (*National Audit Office UK*). Some consider that the auditor (and audit report) should not be the originator of information concerning appropriate use of going concern by management. This would only bring potential misunderstandings or misinterpretations regarding auditor and management responsibilities – a blur between them, thus increasing the audit expectation gap.

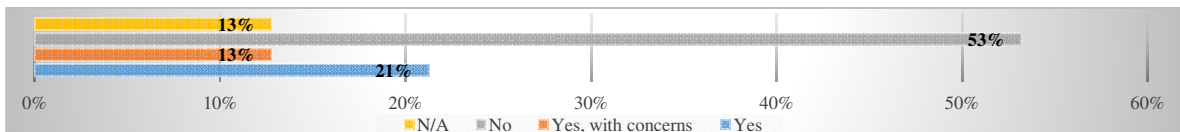


Fig. 3. Answer analysis for IAASB Question 10.

- Question 10: What are respondents' views as to whether an explicit statement that neither management nor the auditor can guarantee the entity's ability to continue as a going concern should be required in the auditor's report whether or not a material uncertainty has been identified?

The IAASB has received mixed views on whether such a statement should be kept in the final standard, because the provided answers are of different opinions. 13% have not provided an answer to this question, while only 21% agree with the statement, as seen in **Fig. 3**.

13% of replies have several concerns with the statement, proposing amended wording (*PwC*): “*it is not possible for any party, including the auditor, to guarantee going concern*”, because “*not all future events or conditions can be predicted*” (*Netherlands Accounting Organisation*). While they agree with the statement, *E&Y* considers it will not help overcome the risk of misinterpretations or confusions regarding auditor and/or management responsibility. In this regard, the *ICAEW* believes the statement is unobjectionable, but they consider it is not in the responsibility of the auditor to make it.

A high percentage of answers (51%) are in disagreement of this statement to be included in the final ISA 570. The *European Court of Auditors* and the *European Banking Authority* consider this statement has political implications, risking the profession to move towards a disclaimer of responsibility – by using a standardised, repetitive and redundant language. Of course, this is not something to be wanted, as the audit profession is already suffering from the audit expectation and communication gap. Some responses reflect that the statement seems to imply that the responsibility of the auditor and management are one and the same, but that it is inappropriate for the auditor to make a statement on behalf of management, as it confuses users regarding responsibilities.

5. Conclusions

The purpose of this study is to provide information about the users' perception regarding the recent developments relating to going concern audit reporting pushed by the IAASB with its recent 2013 Exposure Draft Proposed New and Revised International Standards on Auditing. An invitation to comment. Through this Exposure Draft, the regulating body exposes their proposed regulation for a revised ISA570 – Going Concern. Our goal has been to seek the opinion of EU bodies, organizations and individuals with regards to these proposals. Firstly, we wanted to undertake a review of current trends in the research of this topic, by analyzing relevant studies and also the points of view of different bodies like the IASB, FASB, IAASB and the European Commission. One conclusion regarding this aspect is that regulations regarding the going concern basis of accounting and going concern audit reporting are still under way, with projects from IASB and FASB being under review in the present. Thus, the ISA570 revision is still an ongoing process, and the IAASB has expressed its commitment to work with other bodies for further revision, once future amendments to the underlying accounting standards are known. This, in our opinion, is an important aspect, because all bodies need to work together in order to provide a singular approach to the matter, so that users can easily understand changes and reform. Secondly, our study was focused on determining what the opinion of users regarding the proposed changes is, through an analysis of the received comment letters to the exposure draft. The summary of the answers can be seen in **Table 1**:

Table 1. Summary of questions answers, with answer percentages

Question / Answers	Yes	Yes, with concerns	No	N/A
9. a)	47%	26%	13%	15%
9. b)	23%	19%	26%	32%
10	21%	13%	53%	13%

The audit profession continues to evolve, and audit reform is crucial in order for investors and markets to regain trust in what auditors are offering. Audit reporting on going concern continues to be one delicate issue, especially since investors and users are pressing regulating bodies to increase audit quality and audit usefulness to user. One general conclusion of our study is that, even though users have expressed their concerns regarding IAASBs proposals, the new regulation provides an essential step in improving audit reporting. We are sure the Board will take into considerations the comments they received before issuing a final ISA570. In our study, we have limited ourselves to find the opinion on this matter, from users within the EU. While this is a limitation of the study, it provides an opportunity to further expand our analysis to the full sample of received answers by the IAASB, and also extend to other matters discussed in the Exposure Draft.

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