

Auditor Characteristics and the Issuance of Going Concern Opinion

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Abstract: Auditor should issue Going Concern audit opinion (GC opinion) when there is doubt about the ability of client to continue operation in the next one year, according to International Standard on Auditing 570 (ISA 570). However, in the context of Malaysia auditors tend to issue GC opinion to a small number of financially distress companies only. This situation motivates this study to investigate the effect of three auditor characteristics namely specialization, switching and remuneration on the possibility of GC opinion issuance. The study found significant positive relationship between the amount of auditor remuneration and the issuance of GC opinion. This might be due to operational aspect of auditing as before auditors issue any non-unqualified opinion report they have to conduct additional substantive test, documentation and discussion and negotiation with clients.

Key words: Going concern, opinion, audit quality, auditor, characteristics

INTRODUCTION

It is the role of auditor to issue Going Concern opinion (GC opinion) when there is doubt about client's ability to continue to operate in the foreseeable future (Blay and Geiger, 2013; Sundgren and Svanstrom, 2014). According to the International Standard on Auditing 570 (ISA 570), auditor should issue GC opinion upon realising their client may not be able to continue operations or meet its obligations in the next accounting period. The period is estimated not to exceed more than a year from the date a financial statement has been audited. Specifically, the decision to issue GC opinion has to be made when a client deals with these issues: Inability to pay obligations as they come due, inability to maintain business operation after involving in a legal proceeding, substantial operating losses or working capital deficiencies and/or business faces serious internal problem even though the problem is not financially related such as losing key personnel (Arens *et al.*, 2008).

Furthermore, the ISA 700 makes it mandatory for an auditor to modify audit report by adding a paragraph to highlight a material matter regarding a going concern problem. An auditor is also expected to make it clear to the attention of financial statement users about this pertinent issue in the note of financial statements. When an auditor has substantial doubt about the ability of a client to remain a going concern, he either has to add explanatory paragraph to an unqualified audit report, issue a disclaimer opinion or qualified opinion if disclosure made by the client is inadequate (Arens *et al.*, 2008).

The appropriate issuance of GC opinion is pertinent for the preservation of stakeholder interest. Stakeholders who include investors, customers, suppliers and creditors are the main beneficiary of the issuance of such audit opinion. GC opinion functions as an early signal to the stakeholders about the ability of a company to stay a float and without this signal stakeholders would lose billions of dollars when the company suddenly collapse. Research found that investors change their financial statement analysis methods after a company received GC opinion (Blay *et al.*, 2011), reflecting that GC opinion issuance is a very important factor in investment decision process. Even though auditor should issue GC opinion appropriately, the Financial Statement Review Committee (FSRC) of the Malaysian Institute of Accountants (MIA) reveals that Malaysian auditor issued GC opinion to only a small number of the many financially distressed companies.

Specifically, the FSRC pointed out that the most common weakness in financial statements under their selective review is in the auditor's assessment of the appropriateness of going concern assumption. Zarinah Anwar, the Chairman of Securities Commission (SC) of Malaysia in at least two occasions questioned the practice of Malaysian auditors that tend to issue GC opinion to selected distressed companies only but made significant others an exception. In fact, a recent study found that auditors issued such opinion to only around 21.2% of companies that faced very serious financial problem (Osman *et al.*, 2014).

Studies on GC opinion are plenty. For instance, there are studies on factors affecting auditor judgment in GC opinion process including auditor assignment and age (Sundgren and Svanstrom, 2014), auditor size (Boone *et al.*, 2010), client solvability (Haron *et al.*, 2009) and audit quality attributes, auditor competence and independence (Barbadillo *et al.*, 2004). However, in the context of Malaysia there is at least one unanswered question which is on whether auditor specialization, auditor switching and auditor remuneration can influence the auditor GC opinion decision. In an attempt to address the unresolved question, this study was conducted to examine the effect of auditor specialization, auditor switching and auditor remuneration on the propensity of auditor to issue GC opinion.

Literature review

Going concern opinion: Going concern is an assumption related to the ability of a business to continue its operation in the foreseeable future. An auditor should ensure the financial statement is prepared in a going concern basis unless the management intends to liquidate the business, the business stops trading for some reason, and/or either auditor or its management believes that the firm will not survive in one year period. ISA 570 states that an auditor has the obligation to ascertain the appropriateness of management's use of going concern assumption in the preparation of financial statements. In regards to International Accounting Standard (IAS), management is the one to make judgment about going concern status of a business and the one who is responsible to ensure sufficient disclosure about this issue in the financial statement.

Literature on the predictors of GC opinion issuance in the Malaysian context is limited. In the years pre-2000, there is only one study on this subject and it was conducted by Ismail (1998). Post-2000, a series of studies by Shafie (2009) are the only known published papers on the subject. Recently, Osman *et al.* (2014) reported evidence about the effect of family ownership on GC opinion issuance. Studies on GC opinion in local context are limited but calls for the assessment of the appropriateness of GC opinion issuance have emerged. Knowledge gaps eventually appeared in the literature and one such gap is on whether auditor characteristics such as auditor specialization, auditor switching and auditor remuneration are predictors of GC opinion issuance in Malaysia.

Auditor specialization: Auditor specialization should be seen based on training in auditing in a particular industry

(Lowensohn *et al.*, 2007). Previous studies suggest that the higher the auditor specialization the more likely the auditor could provide, among others, audit quality, the quality of auditor's risk assessment, the appropriateness of audit tests and the allocation of audit hours (Bills *et al.*, 2014; Minutti, 2013). There are at least two arguments that support positive association between auditor specialization and GC opinion issuance. The dominant view is the tendency of this kind of auditor to preserve reputation. Specialized auditors are known to invest on development of reputation in the market and would avoid from being involved in activities that could damage their reputation such as not issuing GC opinion appropriately. Secondly, specialized auditor is more likely to appropriately issue GC opinion because they are knowledgeable and hence could provide higher quality audit compared to non-specialists. A study by Lowensohn *et al.* (2007) explored the consequence of auditor specialization on perceived audit quality and audit fees. Results indicate that there was significant relation between measures of audit specialization and audit quality which is based on the appropriate issuance of GC opinion.

Auditor switching: According to Tu (2012), auditor switching can be defined as replacing an external auditor with a new one because of the resignation or removal the existing external auditor that audited a business's financial statement. Chow and Rice (1982) conducted an early study on this factor. They argued that auditor switching was influenced by the incidence the auditor issued qualified audit opinion to client in prior year, and they found positive association between the two factors. Another study is Schwartz and Menon (1985) which claimed that distress company may switch to a new auditor whose view about auditing is acceptable to management. Management would avoid working with an auditor that will issue unclean audit opinion the kind of auditor which could ruin the capability of the company to secure sufficient financing in the future. A more recent study by Lin and Liu (2010) investigated the relationship between firm's internal corporate governance mechanisms and their auditor switching decisions in the Chinese context. They identified two types of auditor switching, namely switching to a larger auditor and switching to a smaller auditor. The authors found that companies with weak corporate governance would more likely switch to small and easily influenced audit firms. In summary, the literature contends that the incident of auditor switching is more likely to be positively associated with the issuance of an unclean audit opinion such as the GC opinion. An empirical support for this contention can be seen in Citron and Taffler (1992).

Auditor remuneration: Auditor remuneration can be understood as payment received by auditor for doing the statutory audit. This includes payment made for all works done by the auditor or the partner in the firm on its behalf, carried out for individual or group accounts. Researchers have investigated various issues related to auditor remuneration. Wang *et al.* (2009) for instance, examined this issue in relation to China audit market. They found that Big 4 auditors earn fee premiums for general brand name and industry specialization and also found that the auditor remuneration charged by the Big 4 industry specialists were 139% higher compared to non-specialist counterparts in the competitive audit market. Furthermore, a research by Basioudis and Ellwood (2005) found that in the UK context, client size and complexity, as well as client audit risk has a positive impact on auditor remuneration. In relation to the effect of auditor remuneration on GC opinion issuance, DeAngelo (1981) suggested an economic perspective about it the higher the future audit fee revenue can be expected from a client the lower the likelihood that an auditor would issue GC opinion to the client. De Angelo's economic view is supported by, among others, empirical findings reported by Blay and Geiger (2013) who discovered a negative association between auditor remuneration and the issuance of GC opinion in the US context.

MATERIALS AND METHODS

In accordance with research objectives revealed above, this study seeks answers for the following research questions:

- RQ1: To what extent auditor specialization has an effect on the issuance of GC opinion?
- RQ2: What is the impact of auditor switching on the possibility of the auditor to issue GC opinion?
- RQ3: Does the level of auditor remuneration have an effect on GC opinion issuance?

Population, sample selection and data collection: Malaysian companies listed in Bursa Malaysia are the sample population of this study. The sample companies are selected based on two selection criteria: First, the companies are from two industries, namely construction and properties. And second, companies' level of financial distress is very severe and triggers the possibility of the issuance of GC opinion. In this study severe financial distress companies are defined as companies with: Negative working capital and negative cash flow from operating activities. This definition of financially distress

companies is consistent with prior Malaysian studies in this area (Shafie *et al.*, 2009) as well as studies in other contexts (Geiger *et al.*, 1998).

Secondary data is chosen as the source data. The data used in the study was gathered from companies' annual reports obtained from the Bursa Malaysia website. There are many advantages in using secondary data since the data gathered are less expensive, faster, and easier to obtain compared to primary data (Zikmund *et al.*, 2013). And more importantly secondary data is chosen because the research question of this study as mentioned above can be sufficiently answered using this type of data.

Data analysis: The dependent variable for the study is GC opinion (GC) while the independent variables are Auditor Specialization (AUDITORSPEC), Auditor Switching (AUDITORSWITCH) and Auditor Remuneration (AUDITORREMU). The control variables are Client Size (CLIENTSIZE), Auditor Size (AUDITSIZE) and Industry (INDUSTRY). All variables are coded where, GC (1 = GC opinion, 0 = otherwise), AUDITORSPEC (1 = if the auditor has the largest market share in the industry, 0 = otherwise), AUDITORSWITCH (1 = if a company experience a recent change in external auditor, 0 = otherwise), AUDITORREMU (natural logarithm of audit fees), CLIENTSIZE (natural log of total assets (in Ringgit Malaysia) at the balance sheet date), AUDITSIZE (1 = if auditor is a Big 4 auditor, 0 = otherwise) and INDUSTRY (1 = construction industry, 2 = properties industry).

Logistic regression is used in this study to predict the significance of the relationship between independent and dependent variables in the model. This statistic is used given that the dependent variable is nominal data (1 = GC opinion, 0 = otherwise). Also, logistic regression is chosen over other statistics for its less stringent assumption. Discriminant analysis, for instance, can also be used to analyze data in this study and it is robust but it is subject to strict statistical assumptions particularly linearity, normality and multivariate normality with equal variances and covariances (Peng *et al.*, 2002). Furthermore, the application of logistic regression to test relationship between factors and GC opinion is consistent with prior studies on this topic conducted in Malaysia (Shafie *et al.*, 2009) as well as in other contexts (Geiger and Raghunandan, 2002; Geiger *et al.*, 1998). The logistic regression model applicable in this study is expressed as follows:

$$GC = \alpha + \beta_1 \text{AUDITORSPEC} + \beta_2 \text{AUDITORSWITCH} + \beta_3 \text{AUDITORREMU} + \beta_4 \text{CLIENTSIZE} + \beta_5 \text{AUDITSIZE} + \beta_6 \text{INDUSTRY} + \epsilon$$

RESULTS AND DISCUSSION

Descriptive analysis: A total of 102 companies fit the selection criteria of the sample (27 and 20 companies from construction industry in 2011 and 2012, respectively and 28 and 27 companies from properties industry in 2011 and 2012, respectively). Characteristics of the sample are as follows. For the construction industry, in 2012 it can be observed that auditor issued GC opinion to only 30% of financially distressed companies (Table 1). In other words, auditors have not issued GC opinion to around 70% of financially distressed companies even though they should. The figures have not differed much in 2011 where the number was also around 30 and 70% for recipient and non-recipient companies, respectively. However, for the properties industry, only 14.81% of financially distress companies were issued GC opinion in 2012 while in 2011, the figure was only 10.71%. Overall, it can be seen that the rate of GC opinion issuance in construction industry was consistently higher compared to properties industry.

The mean of auditor remuneration variable for construction industry is RM186,185.85 (SD = RM163,176.56) and RM202,760.25 (SD = RM163,255.32), respectively for 2011 and 2012 (Table 2). The minimum range are at RM27,000 and RM22,000 and the maximum range are at RM618,000 and RM625,00, respectively. As for client size variable, measured as client's total assets, the findings show a mean of RM810,764,167.22 (SD = RM1,676,514,929.38) and RM837,244,745.45 (SD = RM1,347,781,215.33), respectively.

Table 1: GC opinion issuance for construction and properties industry in 2012 and 2011

Financially distress companies (N = 102)	2012		2011	
	N (47)	Percentage	N (55)	Percentage
Construction				
GC opinion	6	30	8	29.63
non-GC opinion	14	70.00	19	70.37
Properties				
GC opinion	4	14.81	3	20.71
non-GC opinion	23	85.19	25	89.29

N = Frequency; percentage = cumulative percentage

Table 2: Auditor remuneration and clients size variables for construction and properties industry in 2012 and 2011

Construction industry					
Years	Variables	Mean	SD	Min	Max
2011	Auditor remuneration	186195.85	163176.56	27000	618000
	client size	810764167.22	1676514929.38	23264208	7528033792
2012	Auditor remuneration	202760.25	163255.32	22000	625000
	client size	837244745.45	1347781215.33	27782548	5954817000
Properties industry					
2011	Auditor remuneration	194539.96	121806.00	30000	466000
	client size	874315839.93	813390819.70	62210602	2850381000
2012	Auditor remuneration	246279.37	157669.95	48000	688000
	client size	1236000022.00	1859122872.00	813580	9086485000

S.D = Standard Deviation; Min = Minimum; Max = Maximum; *All values were in Ringgit Malaysia (RM)

The results of the analysis also show that the mean of auditor remuneration for properties industry as RM194,539.96 (SD = RM121,806.00) and RM246,279.37 (SD = RM157,669.95), respectively for 2011 and 2012 (Table 2). The client size variable has a mean of RM874,315,839.93 (SD = RM813,390,810.70) and RM1,236,000,022.00 (SD = RM1,859,122,872.00) in 2011 and 2012, respectively. The figures above show that in the 2 year covered in this study the auditor remuneration (measured as total audit assurance fees) and the size (measured as total assets) of sample companies from properties industry is consistently bigger compared to sample companies from construction industry.

Logistic regression: The logistic regression analysis has been carried out using SPSS. The model summary indicates that between 0.201 and 0.315 of the variability is explained by this set of variables (by Cox and Snell R square and the Nagelkerke R square values, respectively). Thus, between 20.1 and 31.5% of the variability is explained by this set of variables. The classification Table 3 indicates that the GC opinion issuances that have been accurately identified by the model is 19% of the distressed companies.

According to the B weight from the output of logistic regression (Table 3), the regression equation can be expressed as follows:

$$\begin{aligned} GC = & 0.161 - 19.679 \text{ AUDITORSPEC} + 0.305 \text{ AUDITORSWITCH} \\ & + 0.00 \text{ AUDITORREMU} + 0.00 \text{ CLIENTSIZE} \\ & - 0.574 \text{ AUDITSIZE} - 0.960 \text{ INDUSTRY} \end{aligned}$$

The results of logistic regression show that auditor specialization is not significant in predicting GC opinion issuance (Table 3). This is consistent with the results obtained by Barbadillo *et al.* (2004) that the auditor's knowledge or technical ability does not significantly affect the auditor's audit opinion decision. The results also show that auditor switching in financially distress companies has no significant effect on GC opinion

Table 3: Variables in the equation

Variables	B	SE	Wald	df	p-values	Exp (B)
AUDITORSPEC	-19.679	7.360E3	0.000	1	0.998	0.000
AUDITORSWITCH	0.305	0.714	0.182	1	0.670	1.356
AUDITORREMU	0.000	0.000	3.694	1	0.055	1.000
CLIENTSIZE	0.000	0.000	1.535	1	0.215	1.000
AUDITSIZE	-0.574	0.746	0.592	1	0.442	0.563
INDUSTRY	-0.960	0.561	2.934	1	0.087	0.383
Constant	-0.161	0.902	0.032	1	0.858	0.851

B = Coefficient for the constant; SE = Standard Error; Wald = Wald chi-square test; df = Degree of freedom; p = Significance; Exp (B) = Exponentiation of the B coefficient

issuance process which is in contrast to evidence of positive association between these two variables in UK context as reported in Citron and Taffler (1992).

Furthermore, the results of the analysis show that the level of auditor remuneration is significant in estimating the GC opinion issuance ($p = 0.055$). This finding is consistent with research by Basioudis and Ellwood (2005) that indicate the magnitude of the audit fee paid is positively and significantly related to receiving a going-concern modified audit opinion. In the literature it has been contended that high audit fee is associated positively with GC opinion because when auditor has to issue non-unqualified opinion report they have to conduct additional substantive test, documentation and discussion and negotiation with client (Basioudis *et al.*, 2008). Recent evidence reported in Blay and Geiger (2013) however, shows that in the US context the relationship between auditor remuneration and GC opinion issuance is significant but it is a negative relationship. Blay and Geiger (2013) concluded that auditors tend to issue clean audit opinion to clients who would pay high audit fee in the future.

Also, this study found that industries in the control variable has significantly predicted GC opinion issuance, suggesting that distressed companies from certain industries would be more likely to be issued GC opinion by auditor ($p = 0.087$). Specifically, it can be seen in the logistic regression results that in Malaysia the rate of GC opinion issuance to financially distress companies in construction industry is consistently higher over the years compared to the rate of issuance of such audit opinion to companies in properties industry.

CONCLUSION

In Malaysia, standard setters and regulators are concerned about the situation that auditors issued GC opinion to a very small number of financially distress companies. This situation is also reflected in recent studies that found that auditors issued such opinion to only around 21.2% of companies that faced serious financial problems (Osman *et al.*, 2014). This fact motivated this study to examine factors that could predict

the issuance of GC audit opinion. With the general objective to identify auditor characteristics related to GC opinion issuance this study then tested the effect of three variables namely auditor specialization, auditor switching and auditor remuneration on the issuance of such audit opinion. It is found that only auditor remuneration has a significant effect on GC opinion issuance (positive effect, $p = 0.055$). These findings lead to at least two conclusions: In the local context auditors do extensive work (and charge high audit fees) before they issue GC audit opinion to a client and the level of auditor independence seems not at low level as we can see that the auditors tend to issue GC opinion even at a time when they receive high audit fees from clients. Overall, the findings of this study confirms the contention made by Sundgren and Svanstrom (2014) that auditor characteristics should be seen as main factors that could influence the propensity of auditor to issue GC opinion. In addition, this study also found that auditors tend to treat different industry differently.

Future studies should explore the impact of other characteristic of auditors such as tenure and examine the effect of the characteristic of clients on the issuance of GC opinion as well.

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