

Going Concern Emphasis of Matter and Accuracy of Audit Opinion: Italian Evidence

Fabrizio Bava, Melchior Gromis di Trana and Pietro Pisoni
Department of Management, University of Turin, C.so Unione Sovietica 218 bis,
10134 Turin, Italy

Abstract: The study is an empirical investigation in the relationship between Going Concern modified Opinion (GCO) and subsequent insolvency of listed companies in Italy during the period 2008-2012. Prior studies showed that companies which have already received a qualified GCO are more likely than others to receive a repeat qualified GCO within a year. Particular attention was devoted to the relationship between GC emphasis of matter in auditor's opinion, qualified GCO and subsequent insolvency. Two major findings are highlighted. First, the GC uncertainty reported in a GC emphasis of matter 1 year, tends to increase or persist in the subsequent year. Secondly, there is a higher probability of insolvency when a company has received a qualified GCO in the previous year rather than an unqualified opinion with GC emphasis of matter. These results may be a measure of auditing accuracy in auditor's reports.

Key words: Going concern, emphasis of matter, audit opinion, insolvency, subsequent, GCO

INTRODUCTION

The "Global Financial Crisis" (GFC) which originated in the USA financial system in late 2007 because of its links with international business, quickly spread around the globe and also in Italy, the number of listed companies that received a qualified GCO significantly increased (15 qualified GCOs were issued in 2004-2007, against 43 in 2008-2011). At the same time, a greater number of companies received a non-qualified opinion with a GC emphasis of matter paragraph (70 between 2004 and 2007, compared to 94 in 2008-2011) (Pietra *et al.*, 2016). According to Audit Standards (ISA 570), auditors must include a GC emphasis of matter paragraph in their opinion on financial statements when a material uncertainty exists that may cast significant doubt on the company's ability to continue as a going concern and adequate disclosure is made in the financial statements in compliance with accounting standards. Many studies focused on determinants of GCO (Carson *et al.*, 2012 summarise existing research literature) and among these determinants, some studies stated that a company was more likely to receive a GCO in the current year if it had received a qualified opinion in the previous year (Mutchler, 1985). There are few studies based on Italian data (Bava and Gromis, 2013) on the relationship between GCO and the issue of a qualified GCO in the previous year. Recently, Alessandro *et al.* (2016) investigated this topic assuming that an auditor might prefer issuing an EMP in the first year rather than a GCO straightaway. Based on this assumption, we investigated the reason for

issuing an unqualified GCO with emphasis of matter. To this end, we sought to find evidence of the accuracy of auditors investigating the connection between GCOs and subsequent insolvency or bankruptcy.

A first unqualified opinion with a GC emphasis of matter may be interpreted in two different ways. Some consider it only a GC signal of a possible GC problem in the foreseeable future. Others, Alessandro *et al.* (2016), believe that auditors may be reluctant to issue a qualified GCO without a previous emphasis of matter paragraph.

We wanted to verify whether during the GFC, previous literature found confirmation in auditor's opinions of listed companies. We expected that the auditor's decision to issue a GC emphasis of matter or a qualified opinion, depended on the company's financial situation.

To acquire this evidence, we investigated the connection between GCO and subsequent insolvency. The results were in line with prior studies concerning samples of listed companies during GFC (2008-2012). It was found that if an auditor's opinion comprised a GC emphasis of matter of material uncertainty that might cast significant doubt on the entity's ability to continue as a going concern, the GCO of the subsequent year was highly correlated.

Also, the probability of receiving a qualified GCO and subsequent insolvency was higher compared to that of receiving a GC emphasis of matter and subsequent insolvency.

Contrary to some previous research (Alessandro *et al.*, 2016), our findings provided a way of measuring the accuracy of audit reports.

Thus, management and other financial statements users cannot undervalue the GC emphasis of matter, despite the fact that it does not imply a qualified opinion.

Literature review: According to the financial reporting framework (Artical 2423-bis of Civil Code and IAS 1 for listed companies) when preparing financial statements, management is required to make an assessment of an entity's ability to continue as a going concern. If uncertainties are identified, management must make adequate disclosure thereof in the financial statements. Assets and liabilities must be recorded, so that, the entity will be able to realize them in the course of normal business in a foreseeable future. A GC evaluation is indispensable when management does not intend or is not obliged to liquidate the entity or to discontinue operations. On the contrary when the use of a GC assumption is inappropriate assets and liabilities must be recorded according to a different basis of accounting. Moreover, if the financial statements are not prepared on a GC basis, management must highlight it and explain the reasons for it. Management must also clarify the criteria used to draw up the financial statements. Management assessment of the company's ability to continue as a going concern in a foreseeable future, must review all available information in order to ensure that the business will remain operational during at least 1 year after the date of the financial statements. The level of detail of this process depends on specific circumstances such as:

- The background of profitable operations and ease of access to financial resources in which case the capability to conduct business may be considered adequate without detailed assessment procedures
- Otherwise evaluation must review the management assessment process with particular reference to plans and their reliability

ISA 570 requires that throughout the audit process, from planning to issuing the opinion, the auditor shall review the appropriateness of the GC assumption in the preparations of financial statements. Auditors must also verify that any material uncertainties about the entity's ability to continue as a going concern have been disclosed in the financial statements.

The extent of review depends on the financial situation of the company in question. If during the process auditors have significant doubts about the entity's ability to continue as a GC, they must implement additional procedures to prove compliance with GAAP and full knowledge of company performance.

If the review gives rise to doubts on the GC assumption and the financial statements are based on it, GAAP compliance will not be assured. After review, the auditor should determine whether in his judgment:

- The GC assumption is appropriate
- The GC assumption is inappropriate
- Management is willing to make or extend the review

If the GC assumption is considered to be appropriate with reasonable assurance, the auditor will issue an unqualified opinion also known as "clean opinion".

If the GC assumption is considered appropriate, being supported by corrective actions such as business plans, etc., the auditor will consider the information to have been disclosed in the financial statements. The possible scenarios are: adequate disclosure of material uncertainty implying that the entity might be able to continue as a going concern in which case an unqualified opinion would be issued. However, the report would present an emphasis of matter, highlighting the material uncertainty relating to the event or condition that could cast significant doubt on the entity's ability to continue as a GC, drawing attention to the note in the financial statements.

Inadequate disclosure of material uncertainty with appropriate GC assumption, implying a qualified opinion for inadequate disclosure or an adverse opinion if the disclosure inadequacy was so, significant as to prevent the financial statements from reflecting fair financial conditions.

In situations involving multiple material uncertainties significant to the financial statements as a whole in rare cases the auditor might consider it appropriate to express a qualified opinion instead of adding an emphasis of matter paragraph.

According to ISA 701, Paragraph 5 an emphasis of matter paragraph generally highlights a matter affecting the financial statements with a note addressing the matter in more detail.

The emphasis of matter paragraph usually added after the auditor's opinion does not affect the latter which is not qualified in this respect.

The emphasis of matter paragraph is normally neutral for first application in the financial statements of a new accounting principle or a business combination occurring during the year. On the contrary, a paragraph emphasizing a GC problem or significant uncertainty is cause for concern for the stakeholder because uncertainty is a matter the result of which depends on future actions or events not under the direct control of the entity. This study highlights this point because of the possible consequences in terms of GC problems after publication. Both types of reports, qualified opinion and unqualified

opinion with a paragraph emphasizing GC uncertainty, have been classified by the empirical literature as modified audit opinions (Lennox, 2000).

Assessing the appropriateness of management's use of the going concern basis of accounting when preparing financial statements is highly subjective. Consequently, auditors could sometimes face the dilemma of issuing a qualified opinion versus an unqualified opinion with a GC emphasis of matter. This type of report could sometimes be used by auditors to highlight inconclusive evidence or as a disguise for a qualified opinion. Thus, the emphasis of matter paragraph is highly critical in spite of the unqualified opinion.

Users may interpret unqualified opinion with emphasis of matter differently with a paragraph disclosing uncertainties compared to qualified or unqualified reports. In Italy, the topic of going concern disclosure will become increasingly important in the future because from the next financial statements (year, 2017), the inclusion of a going concern disclosure in auditor unqualified opinion will be mandatory (Legislative Decree, 39/2010).

The law requires disclosure of any material uncertainty about the ability of the entity in question to continue as a going concern.

Prior studies stated that when a company meets financial distress, the condition is of a persistent nature and it is to be expected that there would also be persistence in the issuance of a GC opinion. An auditor may be reluctant to issue a non-qualified opinion in the current year if in the previous year the company received a GCO, unless there is evidence of an improvement in the company's financial conditions. In particular, Mutchler (1985) was the first to show that a company is more likely to receive a GCO in the current year if it received a GCO in the previous year. Similar results were reported by Lennox (2000), Carcello and Neal (2003), Vanstraelen (2003) and Chan *et al.* (2006). There are few similar studies with data on Italy (Alessandro *et al.*, 2016).

In the next study, we review the assumptions made, discuss the research method and the data used for analysis. After presenting the empirical results obtained, the study concludes with a discussion of results.

MATERIALS AND METHODS

An investigation was made of the relationship between the different GCOs issued by auditors from 2008-2012, aiming to verify redundancy and identify the reasons behind the auditor's decisions. These aims are outlined in the following three hypothesis:

- H₁: modified GC opinions (qualified as well as with emphasis of matter) increase the likelihood of qualified going concern opinions in the subsequent year

In H₁ we looked for possible correlation between a qualified GCO in the current year and a modified GCO (qualified or with emphasis of matter) in the previous year. As suggested by previous studies (Mutchler, 1984; Mutchler and Williams, 1990), a positive correlation was expected, meaning that previous-year qualifications were not easily removed.

- H₂: auditors are more likely to issue an unqualified opinion with GC emphasis of matter in the current year if they issued a unqualified opinion with GC emphasis of matter in the previous year

In H₂ we looked for correlation between the exception for GC in emphasis of matter of unqualified opinions versus modified opinion for GC (GCO). Some studies (Alessandro *et al.*, 2016) suggested that auditors were more likely to issue a qualified opinion after issuing GC uncertainties in the previous year also for unqualified reports as in the previous year auditors may have been reluctant to issue a GCO right away.

Another explanation may be given for the expected positive correlation. The probability of receiving an unqualified opinion with GC emphasis of matter may be higher if auditors issued an unqualified opinion with GC emphasis of matter rather than a qualified GCO in the previous year.

When there are uncertainties on the appropriateness of the basis of accounting by GC management in the preparation of financial statements such uncertainties will probably also apply to the subsequent year. In some cases the resulting increased GC uncertainty could cause auditors to issue a GCO in others to confirm an unqualified opinion but with emphasis of matter. This may give rise to doubts on the assumptions made by prior studies concerning auditor's reluctance to issue a GCO right away (Alessandro *et al.*, 2016):

- H₃: the probability of opening an insolvency proceeding is higher after receiving a qualified GCO than after a GC exception in emphasis of matter

Our purpose was to verify the accuracy of auditor's opinions. The positive correlation between insolvency and qualified GCO in previous years was expected to be stronger than that between insolvency and unqualified opinion with GC emphasis of matter as evidence of accuracy of auditor's opinions. This result suggests that

auditors issue a GC emphasis of matter when GC uncertainties are less material than when they issue a qualified GCO confuting the reluctance to issue a qualified GCO right away.

Sample: Based on previous literature, we focused on financially distressed companies because auditors almost never issue GC opinions to healthy companies (McKeown *et al.*, 1991).

We selected companies that incurred at least once in a GC problem in the period 2008-2012 our sample consisting only of companies whose level of financial distress was high enough to prompt auditor's to evaluate their GC status. This is a more stringent measure of financial stress compared to prior literature that defined stressed companies as those with negative net income or negative operating cash flow (DeFond *et al.*, 2002).

The sample included companies quoted at least once in CONSOB (Italian equivalent of the Securities and Exchange Commission) "black" or "gray" list which comprise listed companies subject to more frequent requirements of information disclosure, pursuant to art. 114 of Legislative Decree, February 24, 1998, No. 58. Blacklisting is decided by Consob on the basis of two elements, the company has incurred losses of more than 1/3 of its equity or the company has received an audit opinion with GC qualification. The latter is known as a "grey list" case and refers to companies for which the auditors issued a GC emphasis of matter paragraph.

In all, 53 listed companies were involved from 2008-2012 (5 years). The 265 companies-year was reduced due to delisting and failure. For a few of them

(which failed after 2012) no official data were found and had to be excluded. The final sample consisted of 217 companies-year. The data was collected by Thomson Reuters datastream database.

Model design: Our analysis was based on a logistic regression model for testing the dichotomous dependent variables using independent variables identified in previous literature and our own test variables. The first two models were based on the following structure:

$$Y_{it} = \alpha_0 + \beta_1 PGCO_{it-1} + \beta_2 PEMP_{it-1} + \beta_x (\text{Control variables})_{it} + \varepsilon_{it} \tag{1}$$

where, firm = i and year = t. Table 1 shows the two dependent variables that characterized the first two models that we perform to verify H₁ and H₂.

These test variables are the target of our observation. We aim verifying the attitude of these variables to influence our dependent variables (Table 2).

Control variables (Table 3) were as identified in previous literature as they are likely to affect audit opinion decisions. To answer H₃, model 1 and 2 dependent variables were converted to independent variables, thereby verifying the relation between type of opinion and insolvency. The model adopted was:

$$INS_{it+1} = \alpha_0 + \beta_1 PGCO_{it} + \beta_2 EMP_{it} + \beta_x (\text{Control variables})_{it} + \varepsilon_{it} \tag{2}$$

This variable characterized our third model that, we perform to verify H₃ (Table 4). These test variables are the target of our observation. We aim verifying the attitude of

Table 1: Dependent variables

Models	Variables	Definition	Literature
1	GCO _{it}	Dummy variables equal 1 if the company received a qualified opinion, otherwise 0	Mutchler (1985), Carcello and Neal (2000) and Myers <i>et al.</i> (2014)
2	EMP _{it}	Dummy variables equal 1 if the company received emphasis of matter paragraph, otherwise 0	Alessandro <i>et al.</i> (2016)

Table 2: Test variables

Variables	Definition	Literature
PGCO _{it-1}	Dummy variables equal 1 if the company received a qualified opinion in the previous year, otherwise 0	Mutchler (1985) and Carcello and Neal (2000)
PEMP _{it-1}	Dummy variables equal 1 if the company received emphasis of matter paragraph in the previous year, otherwise 0	Alessandro <i>et al.</i> (2016)

Table 3: Control variables

Variables	Definition	Literature
SIZE _{it}	Natural logarithm of tot. assets	Chen <i>et al.</i> (2010), McKeown <i>et al.</i> (1991) and Carcello <i>et al.</i> (1995)
PLOSS _{it-1}	Dummy variables equal 1 if the company posted a positive net income in the previous year, otherwise 0	
ZM	Zmijewski's financial condition score (1984) ZM = -4.336 - 4.512 × (net income/total assets) + 5.679 × (total liabilities/total assets) + 0.004 × (current assets/current liabilities). Higher values represent a higher risk of bankruptcy	Carcello <i>et al.</i> (1995, 2000 and 2009), DeFond <i>et al.</i> (2002) and Geiger <i>et al.</i> (2006)
BIG4	Dummy variables equal 1 if the auditor is a member of BIG4, otherwise 0	Geiger <i>et al.</i> (2005, 2013)
Revenues/total assets	Ratio of total sales to total assets represents capital turnover	McKee (2003)

Table 4: Dependent variable

Model	Variable	Definition	Literature
Model 3	INS _{it+1}	Dummy variables equal 1 if the company incurred subsequent insolvency, otherwise 0	Alessandro <i>et al.</i> (2016)

Table 5: Test variables

Variables	Definition	Literature
GCO _{it}	Dummy variables equal 1 if the company received a qualified opinion, otherwise 0	Mutchler (1985), Carcello and Neal (2000) and Myers <i>et al.</i> (2014)
EMP _{it}	Dummy variables equal 1 if the company received emphasis of matter paragraph, otherwise 0	Alessandro <i>et al.</i> (2016)

Table 6: Pearson's correlation

Variables	1	2	3	4	5	6	7	8	9	10
INS	-									
GCO	0.642**	-								
EMP	-0.288**	-0.447**	-							
PGCO	0.369**	0.392**	-0.062	-						
PEMP	-0.014	0.010	0.376**	-0.322**	-					
PLOSS	0.026	0.010	-0.287**	0.003	-0.361**	-				
ZM	-0.003	0.083	0.084	0.172*	0.044	-0.121	-			
BIG4	-0.106	-0.111	0.146*	-0.160*	0.243**	-0.095	-0.027	-		
SIZE	0.018	-0.137*	0.143*	-0.173*	0.150*	-0.024	-0.200**	0.315**	-	
CAPTURN	-0.040	0.106	0.023	-0.025	0.110	0.006	0.260**	-0.062	-0.155*	-

**Correlation is significant at 0.02 level (2-tailed); *Correlation is significant at 0.05 level (2-tailed)

these variables to influence our dependent variables (Table 5). Control variables are the same as for the other models.

RESULTS AND DISCUSSION

Empirical analysis started with a propaedeutic correlation analysis as shown in Table 1. Significant correlations (statistical significances are *when $p < 0.05$ or ** when $p < 0.02$. Significance means the probability of the study rejecting the null hypothesis, given that it were true), measured by Pearson was found to exist between several pairs of variables (Table 6). These correlations suggested the need for a multi-collinearity test. A strong correlation between INS and GCO was the basis for H3. Other moderate correlations were identified between PGCO and INS and also between GCO and PGCO and PEMP and EMP (H₂). In Model 1 (Table 7) with logistic regression statistics was applied to verify H₁. The dependent variable was GCO.

GCO was found to be positively and statistically correlated (their statistical significances are both < 0.01) to a previous GCO opinion as well as to emphasis of matter in the previous year. The other variables were not statistically confirmed. The absence of a correlation between ZM and GCO was due to the nature of the sample. Companies of this type are highly distressed, a fact that reduces the relevance of the variable. The explanatory power of the models is satisfactory with Pseudo R² of 18%. This means that the GC issue in the opinion increases the probability of a GCO in the subsequent year. Thus it is very difficult for a company with a GCO or an emphasis of matter to overturn its

situation. VIF scores are within acceptable limits. Model 2 (Table 8) was applied to verify H₂. The dependent variable was EMP.

EMP was positively and statistically correlated (its statistical significance is < 0.01) to GC emphasis of matter of previous year. The relation between EMP and PGCO was not statistically verified. This confirms that emphasis of matter might persist during more than 1 year. Moreover, PLOSS and EMP were negatively and statistically associated (its statistical significance is < 0.02), i.e., a negative net income in the previous year increased the probability of an EMP the subsequent year. The other variables were not statistically confirmed. The explanatory power of the models was satisfactory for Pseudo R² of 18.2%. VIF scores were within acceptable limits.

Finally, Model 3 was designed to verify auditor accuracy (Table 9). Whether a GCO would have been more predictive than other variables for predicting insolvency was verified. INS was positively correlated to a GCO of the previous year (its statistical significance is < 0.01). The association with EMP was not statistically confirmed. This was confirmation that the opinion was adequate for the foreseeable future of the company. Furthermore, the model identified an inverse correlation between size and INS (its statistical significance is < 0.02). This was in contrast with the literature but may be explained by the specific nature of our sample which considered only companies of below-average size.

The other variables were not statistically confirmed. The explanatory power of the models was satisfactory for pseudo R² of 35.2%. VIF scores were within acceptable limits.

Table 7: Logistic regression (Model 1)

Variables	Expected sign	B	Wald	Exp(B)	VIF
PGCO	+	2.887***	29.857	17.948	1.178
PEMP	+	1.329***	7.660	3.778	1.381
PRELOSS	-	0.478	1.263	1.613	1.186
ZM		-0.009	0.456	0.991	1.157
BIG4		-0.414	1.063	0.661	1.152
SIZE		-0.345	1.600	0.708	1.174
CAP/TURN		0.241	1.576	1.272	1.116
Costant		-0.583	0.208	0.558	-

***Correlation is statistically significant at 0.01 level (2-tailed); $\chi^2 = 42.325$ ***; Percentage correct = 81.200; Pseudo R² = 0.180; N = 0.217

Table 8: Logistic regression (Model 2)

Variables	Expected sign	B	Wald	Exp(B)	VIF
PGCO	+	0.330	0.474	1.390	1.178
PEMP	+	1.434***	15.296	4.196	1.381
PLOSS	-	-0.859**	5.438	0.423	1.186
ZM		0.014	1.072	1.014	1.157
BIG 4		0.162	0.195	1.176	1.152
SIZE		0.374	2.365	1.454	1.174
CAP/TURN		-0.042	0.041	0.959	1.116
Costant		-2.768*	5.244	0.063	-

***Correlation is statistically significant at 0.01 level (2-tailed); **Correlation is statistically significant at 0.02 level (2-tailed); *Correlation is statistically significant at 0.05 level (2-tailed); $\chi^2 = 42.838$ ***; Percentage correct = 72.3; Pseudo R² = 0.182; N = 217

Table 9: Logistic regression (Model 3)

Variables	Expected sign	B	Wald	Exp(B)	VIF
GCO	+	5.7370***	20.888	310.130	1.348
EMP	+	0.2530	0.030	1.287	1.385
LOSS		-0.0250	0.001	0.975	1.152
ZM		-0.0590	0.674	0.943	1.161
BIG4		-1.1080	2.475	0.330	1.118
SIZE		0.1671**	6.568	5.319	1.198
CAP/TURN		-0.3350	0.212	7.150	1.108
Costant		-12.6740***	11.251	0.000	-

***Correlation is significant at 0.01 level (2-tailed); **Correlation is significant at 0.02 level (2-tailed); $\chi^2 = 92.502$ ***; Percentage correct = 89.7; Pseudo R² = 1.352; N = 217

CONCLUSION

The increasing number of Italian listed companies receiving a GCO during the global financial crisis has stimulated public interest in GCs. Our study sheds light on the debate about the quality and accuracy of auditor's opinions. Financial statements users may consider a GC emphasis of matter only as a signal of possible GC problems in the future or as reluctance of auditors to issue qualified GCOs without previous emphasis of matter paragraph. Prior studies stated that when a company is in financial distress, this condition is persistent and persistence would also affect the issuance of GC opinions. The results of empirical analysis are consistent with our assumption that a GC emphasis of matter paragraph of unqualified opinion signals GC uncertainty but less, so, compared to qualified opinion (H_1 , H_2). In fact, there is a stronger positive correlation between qualified GCO and subsequent insolvency than for unqualified GCO with emphasis of matter (H_3).

RECOMMENDATIONS

Future studies could address investigation of type 1 and 2 misclassifications to improve assessment of

auditor's quality. These findings should be useful to users of financial statements for evaluating the risk of unqualified opinion when audit reports include GC emphasis of matter paragraph. Due to the recent provision for mandatory paragraph in auditor's reports about material uncertainty, possibly casting significant doubt on a company's ability to continue as a going concern, this topic is the subject of debate among auditors and scholars. The results also provide information useful to management and board of directors for understanding going concern risks and implementing the necessary corrective actions before a company crisis becomes irreversible.

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