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Company Management's and Auditor's Reporting on Going Concern: Discussion of the Current International Regulatory Framework

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Abstract

In this study, we discuss if the current (international) regulatory framework regarding accounting and auditing provides an adequate basis for both company management and the auditor to report (accurately and informatively) on going concern.

Overall findings indicate that from a theoretical perspective the changes made in the design of the framework since the last global economic crisis contribute to more accurate and informative reporting on going concern. This starts with an increased focus on substantiated reporting on long-term value creation and continuity in the U.K. and Dutch corporate governance codes. Furthermore, the current Dutch and U.S. accounting standards

increasingly pay attention to reporting on going concern. Also several changes in the Dutch, international and (partly) U.S. auditing standards could have a positive impact, such as the requirement to state the responsibilities of both company management and the auditor in each auditor's report, and the introduction of key audit matters offering the possibility to report on going concern risks and the audit procedures performed.

There is, however, still room for improvement. It seems that various standard setters have determined their own route and pace, which may have kept them from implementing more progressive proposals such as a conclusion and a statement on going concern in each auditor's report. As a result, the exception-based reporting model is still largely retained. Further progress can be made by implementing a so-called holistic approach to ensure that the responsibilities of company management and the auditor are aligned, and by striving for more international convergence.

Keywords: Going concern, Bankruptcy, Corporate governance, Accounting, Auditing, Holistic approach, Regulatory framework

1. Introduction

During the economic crisis that started in 2007, globally many companies have filed for bankruptcy. Bankruptcies however are of all times. For most parties a bankruptcy occurs by surprise, because they are only afterwards informed about the financial position of a company. Company management and the auditor, however, could be in a position to foresee the forthcoming bankruptcy and to issue a warning signal. Both academic research and press coverage show that warning signals from the auditor are not considered accurate and have limited informative value (e.g. Carson et al., 2013).

In blaming those responsible, the focus often is on the auditor and questions have been asked like: 'Where was the auditor?' (e.g. Akers, Maher, & Giacomino, 2003; NBA, 2018c). The global economic crisis gave a new impulse to academic research into auditor's reporting on going concern issues (e.g. Ettredge, Fuerherm, Guo, & Li, 2017; Geiger, Raghunandan, & Riccardi, 2014; Sanoran, 2018; Xu, Carson, Fargher, & Jiang, 2013). In most prior academic research on auditor's reporting on going concern no (explicit) attention is paid to company management's responsibilities.

When a crisis occurs, legislators and standard setters often react with amendments of the rules and legislation (e.g. Farrar, Parsons, & Joubert, 2009), which is also the case regarding reporting on going concern. Since the global economic crisis, several proposals have been made to improve the reporting on going concern. In this study we examine whether the current (international) regulatory framework regarding accounting and auditing provides an adequate basis for both company management and the auditor to report (accurately and informatively) on going concern.

The remainder of this study is organized as follows. In section 2 we will review prior literature resulting in our research question. This will be followed by an explanation of the research methodology used in section 3. In section 4 we will present our research findings. We will conclude this study in section 5 with a discussion and conclusions.

2. Literature Review and Research Question

In auditing the financial statements, the auditor plays an important role in the financial reporting chain. For many stakeholders, however, the audit is some kind of a black box (e.g. Cordoş & Fülöp, 2015b). The auditor's report is the most visible form of communication by the auditor (e.g. Blay, Geiger, & North, 2011; Carson, Fargher, & Zhang, 2016; DeFond & Zhang, 2014).

Academic research shows mixed results about the perceptions and added value of an auditor's report in general (e.g. Asare & Wright, 2009, 2012; Church, Davis, & McCracken, 2008; Coram, Mock, Turner, & Gray, 2011; Gold, Gronewold, & Pott, 2009; Gray, Turner, Coram, & Mock, 2011; Mock et al., 2013; Mock, Turner, Gray, & Coram, 2009; Porter, Ó hÓgartaigh, & Baskerville, 2009). The question arises how problematic this is when the financial statements give a true and fair view and the auditor issues an unmodified auditor's report (Note 1). This could be different, however, when the auditor modifies (or should modify) his opinion or, for example, includes (or should include) an emphasis of matter paragraph in his report. Historically, one of the most common situations an auditor modifies the report is in case of going concern issues (e.g. DeFond & Zhang, 2014; Xu, Jiang, Fargher, & Carson, 2011). Whether to give a warning for going concern issues is one of the most difficult (e.g. O'Reilly, 2009) and important (e.g. Barnes & Renart, 2013) decisions an auditor has to make.

Academic research shows mixed results regarding auditor's reporting on going concern issues. Based on an analysis of prior academic research, we make a distinction between accuracy and informativeness (Note 2).

Academic research on the *accuracy* of auditor's reporting is mainly focused on Type I and Type II errors. According to the literature, a Type I error occurs when an auditor warns for going concern issues of a subsequently viable company, where a Type II error occurs when a company goes bankrupt without a prior going concern warning from the auditor. The error rates can be labelled as rather high. In their research synthesis on auditor's going concern reporting, Carson et al. (2013) report Type I and Type II error rates of 80 to 90 per cent respectively 40 to 50 per cent for U.S. companies. DeFond and Zhang (2014) report similar error rates in their review of archival auditing research, like several other researchers do (e.g. Carey, Kortum, & Moroney, 2012; Carson et al., 2016). The impact of such Type I and Type II errors can be rather profound, such as higher financing costs and auditor-switching in case of Type I errors (e.g. Amin, Krishnan, & Yang, 2014; Carson et al., 2013; DeFond & Zhang, 2014), and litigation costs and reputational damage for the auditor in case of Type II errors (e.g. Carson et al., 2013; DeFond & Zhang, 2014; Kaplan & Williams, 2013).

It could also be questioned whether the auditor's report contains *informative value* in the context of going concern issues (Note 3). Prior research regarding the informative value of going concern auditor's reports shows mixed results (e.g. Abad, Sánchez-Ballesta, & Yagüe, 2017; Amin et al., 2014; Blay et al., 2011; Feldmann & Read, 2013; Fischer, Marsh, & Brown, 2016; Ianniello & Galloppo, 2015; Kausar & Lennox, 2017; Kausar, Taffler, & Tan, 2017; Mock et al., 2013; O'Reilly, 2009), mostly measured based on market reaction or an experiment among financial statements users.

Analysis shows that where academic research addresses the role of the auditor, it hardly (explicitly) focuses on the role of company management regarding going concern reporting (Note 4). This is remarkable, as the auditor has to give an opinion whether or not the information provided by company management gives a true and fair view (Note 5). It therefore seems logical that also the role of company management would be taken into account relating to going concern. Based on their extensive research synthesis on auditor's going concern reporting, Carson et al. (2013, p. 376) state '*a challenging, but needed, area of research is to better distinguish between management, audit committee, and auditor roles in the disclosure and discussion of going-concern uncertainties.*'

In view of the results from prior academic research, the following *research question* arises: *Does the current (international) regulatory framework regarding accounting and auditing provide an adequate basis for both company management and the auditor to report (accurately and informatively) on going concern?*

3. Research Methodology

The method used in this study is a content analysis and interpretation of documents such as exposure drafts and final versions of applicable rules, as well as comments on it. In applying this method, we not only focus on the current state of the regulatory framework, but also reflect on the background of developments of the regulatory framework and the choices made. We also include prior academic research in our analysis.

In this study, we analyze the current regulatory framework (Table 1) from two perspectives. First, in section 4 we focus separately on company management and the auditor as they both have their own role and rules regarding reporting on going concern. For company management corporate governance codes and accounting rules apply, while for the auditor the auditing rules apply. This perspective allows us to conclude whether developments in each of these separate parts of the regulatory framework have contributed to an adequate basis to reporting (accurately and informatively) on going concern by both parties involved. Second, in section 5 we will discuss from a cross-sectional perspective how these separate parts of the regulatory framework relate to each other because those responsibilities are connected to each other, as it is company management's responsibility to prepare the financial statements and the auditor's responsibility to audit these financial statements. An analysis from a cross-sectional perspective enables us to determine whether accounting and auditing standard setters have used a so-called *holistic approach* (e.g. IAASB, 2015c, 2015d). Such a holistic approach should ensure the responsibilities of company management and the auditor are aligned, resulting in improved reporting on going concern. In this study therefore, the approach for reporting is considered 'holistic' if the legislators and standard setters take into account the responsibilities of both company management and the auditor as a whole and align them, instead of each legislator or standard setter focusing solely on company management or the auditor (Note 6).

Table 1. Overview of regulatory framework (Note 7)

	Company management		Auditor
	Corporate governance codes (§4.1)	**Accounting rules** (§4.2)	**Auditing rules** (§4.3)
Netherlands	Dutch Corporate Governance Code	Dutch Civil Code Dutch Accounting Standards	Dutch Auditing Standards
European Union		Directive 2013/34/EU Regulation (EC) No 1606/2002 IFRS-EU	Directive 2014/56/EU Regulation (EU) No 537/2014
International		IFRS	International Standards on Auditing
United Kingdom	U.K. Corporate Governance Code		
United States		U.S. GAAP	U.S. GAAS (AICPA & PCAOB)

This study focuses primarily on the Dutch context, which is interesting because the Netherlands has been an international frontrunner regarding the introduction of the extended auditor's report. Since the Dutch regulatory framework is (partly) based on European and other international rules and legislation, these will also be discussed, including the United States (hereafter: U.S.) accounting and auditing standards because of the role of the United States in the global financial market. In this study also a comparison will be made with the corporate governance code in the United Kingdom (hereafter: U.K. Code), being the cradle of corporate governance codes (e.g. Matis, Manoiu, & Damian, 2016).

4. Research Findings

4.1 Corporate Governance Codes

Comparing the U.K. Code and the Dutch corporate governance code (hereafter: Dutch Code), in this section the main findings whether or not these codes provide an adequate basis for *management* to report on the going concern perspectives of a company are discussed (Note 8).

4.1.1 U.K. Code

Since the 2014-edition of the *U.K. Code* (FRC, 2014), long-term value creation and continuity have been given a more explicit place. Two provisions explicitly require management to report on the continuity of the company. At first provision C.1.3 (FRC, 2016, p. 16) requires management to give a statement about the appropriateness of the going concern basis of accounting. Furthermore, this provision requires management to identify material uncertainties, which could threaten the continuity of the company in the period of 12 months from the approval-date of the financial statements. Secondly, provision C.2.2 (FRC, 2016, p. 17) goes a step further, stating management should report in a 'viability statement' more details of their assessment of the prospects of the company. Complying with provision C.2.2 requires considerable effort. Management should have a continuous insight in the factors that enable the company to create value and in the risks that could threaten those factors. In preparing such a 'viability statement', management has to perform qualitative and quantitative analyses and to include well-substantiated explanations. The period management has to consider is no longer a 'standard period' of 12 months after the end of the reporting period, but in many situations a future period of three to five years.

According to the U.K. Code the auditor has to determine whether or not the information in the 'viability statement' is in line with the knowledge he obtained during the audit. Furthermore, he has to perform a deep and substantive assessment in order to state material matters concerning the 'viability statement' in his auditor's report. In our opinion, the requirements of provisions C.1.3 and C.2.2 go far beyond the primarily implicit use of the going concern basis of accounting in the normal course of preparing the financial statements.

4.1.2 Dutch Code

Considering the frontrunners role of the U.K. Code and the strive for international convergence, we would expect the 2016-edition of the *Dutch Code* to be in line with the U.K. Code. As with the U.K. Code, long-term value creation has also been introduced in the 2016-edition of the Dutch Code (MCCGC, 2016a), partly motivated by the crisis and by misconduct in the past by company management due to the primarily short-term focus, resulting in bankruptcies.

Principle 1.1 of the Dutch Code immediately gives long-term value creation a prominent place (MCCGC, 2016a, p. 13), stating the management board is responsible for the long-term value creation and continuity of the company, and has to take stakeholders' interests into account. The consultation process of the draft code did not result in strong resistance related to this principle (Note 9). This was quite different with regard to the proposed principle 1.4.2 (MCCGC, 2016b, p. 16). This principle, inspired by the U.K. Code, required a so-called 'in-control statement' including an explicit statement '*that it is expected that the continuity of the company is guaranteed for the next twelve months*' (a 'continuity statement'). The consultation process showed that there were both opponents and proponents regarding a 'continuity statement'. The opponents of the 'continuity statement' were mainly employers and law firms. Their main objections relate to three aspects. First, some opponents considered the formulation of this part of the in-control statement too broad, offering 'little room for

nuance'. Second, some opponents were worried about the liability risk of company management. Third, several opponents were afraid of 'boilerplate' wording. The proponents of the 'continuity statement' were mainly audit firms, the Netherlands Institute of Certified Accountants (NBA) (Note 10) and a representative body of institutional investors. Some of these parties even argued for a Dutch variant of the 'viability statement'. It seems that the arguments of the opponents have outweighed those of the proponents as in the final version the explicit 'continuity statement' as part of the in-control statement has been removed. Instead, principle 1.4.3 requires a statement of the management board that '*based on the current state of affairs, it is justified that the financial reporting is prepared on a going concern basis; and the report states those material risks and uncertainties that are relevant to the expectations of the company's continuity for the period of twelve months after the preparation of the report*' (MCCGC, 2016a, p. 15).

4.2 Accounting Rules

In this section the main findings whether or not the *accounting rules* provide an adequate basis for *management* using and reporting on the (non) going concern basis of accounting in the financial statements are discussed (Note 11).

4.2.1 Dutch Accounting Rules

The *Dutch Accounting Rules* (Note 12) distinguish between situations in which a company is expected to continue to exist and situations in which this is uncertain or it is certain that the company will cease to exist, to ensure that the financial statements provide the required insight (as required by article 2:362 of Part 9, Book 2 of the Dutch Civil Code). In addition to the general insight requirement, article 2:384 paragraph 3 includes the so-called continuity-assumption, which implies that the financial statements are based on the continuity of the company, unless there is substantial doubt about it. In case of substantial doubt, this should be disclosed in the explanatory notes, including the effect on result and equity. A short review of the legislative history of this article shows there hardly has been discussion about it (Note 13). Although formulated rather generally, this article according to the legislator probably gives enough guidance. In our opinion, however, these legal provisions provide no more than limited guidance to company management.

The *Dutch Accounting Standards* in contrast provide company management some more guidance (Note 14). Standard 110 *Objectives and starting points* makes reference to the articles 2:362 and 2:384 of the Dutch Civil Code. Although the Dutch corporate governance code and the auditing standards do mention a specific period (e.g. 12 months after the reporting period) to consider in relation to the going concern assumption, the Dutch Accounting Standards do not mention a specific period at all. Standard 170 *Discontinuity and serious uncertainty about continuity* is probably the most important Dutch Accounting Standard in the context of going concern issues (Note 15, 16). Regarding the disclosure management should provide in case of serious uncertainty about continuity, the standard just states that '*an adequate explanation of the circumstances in which the legal entity is situated should be included in the explanatory notes*'. Although the standard gives some examples, these are limited to the fields of finance and business management. In this way, this standard

gives only limited guidance about accounting in the situation of *serious uncertainty* about continuity, while in our opinion there is a big need for such guidance. In case of *inevitable discontinuity*, standard 170 gives concrete examples of the impact of discontinuity on the accounting of assets and liabilities. The standard also gives an enumeration of additional disclosures management should provide. We are therefore of the opinion, this standard provides pretty concrete guidance how to account for inevitable discontinuity.

Furthermore, standard 400 *Management report* sets requirements for *management* to report on risks more extensive than before, effective as of financial statements 2015. The management report should provide insight into the risk appetite, control measures, the potential impact of risks based on sensitivity analyses, the most important risks that have occurred and their impact and possible improvements in the risk management system. These requirements give management the opportunity to provide insight into going concern risks, and how these risks are handled. However, as also stated by the NBA (2018c), improvements can still be made, e.g. by requiring a continuity analysis. Furthermore, management has the option to provide the report only on request, which in our opinion does not contribute to transparent reporting about going concern risks.

4.2.2 International Financial Reporting Standards (EU)

In addition to the Dutch accounting rules, Dutch medium sized and large companies are also obliged (securities issuers listed on a regulated market) or allowed (other companies) to report on the basis of IFRS as endorsed by the European Union (*IFRS-EU*), based on Regulation (EC) No 1606/2002. In the context of reporting on (dis)continuity, the IFRS-EU is equal to the IFRS. In contrast to the Dutch Accounting Standards, the IFRS-EU includes no specific standard regarding reporting on (dis)continuity. However, standard IAS 1 *Presentation of financial statements* and standard IAS 10 *Events after the reporting period* explicitly refer to (dis)continuity.

IAS 1.25 requires company management to make an explicit assessment of the so-called *going concern assumption* of the entity. The going concern basis of accounting is applicable, unless company management intends to or has to liquidate the company or to cease trading. Company management has to disclose any uncertainties regarding going concern. If the financial statements are not prepared on a going concern basis of accounting, this should be disclosed including the reason and the applied basis of accounting. The disclosure requirements, however, seem to be rather general. According to paragraph IAS 1.26, company management should assess a period of at least 12 months from the end of the reporting period. Furthermore, this paragraph includes some limited guidance on the required degree of consideration that differs between cases of a profitable history and available financial resources and other cases.

In June 2012 the international auditing standard setter (IAASB) requested the international accounting standard setter (IASB) for an amendment of IAS 1, comprising clarification of disclosure requirements in the context of material going concern uncertainties. In November 2013 the IASB decided not to amend IAS 1, because e.g. the requested amendment would be an auditing instead of an accounting matter, additional disclosure requirements would have negative consequences, boilerplate type disclosures need to be avoided, and IAS 1 would

already work well. Also a tentative agenda decision in 2014 regarding 'close call' decisions related to going concern issues did not make it in the end.

Finally, IAS 10.14 also includes a specific requirement related to going concern issues that arise after the reporting period. When the so-called going concern assumption is no longer applicable due to events after the reporting period, the financial statements have to be prepared on another basis than the going concern basis of accounting. As IAS 1, IAS 10 does not provide additional guidance.

4.2.3 U.S. GAAP

In the United States for many years guidance related to going concern evaluations has been located in the U.S. *auditing* standards and not explicitly in the U.S. *accounting* standards (e.g. Booker & Booker, 2016; Clikeman, 2018; Holzmann & Munter, 2015; Seyam & Brickman, 2016; Trainor et al., 2018). In addition, going concern evaluations received not much attention in the U.S. accounting literature for a long time (Hahn, 2011). According to the U.S. Financial Accounting Standards Board (FASB) (FASB, 2014), this situation resulted in diversity in going concern reporting by company management.

In its pursuit of convergence with international accounting standards, in 2007 the FASB started a long-term project that ultimately resulted in the issuance of a new Accounting Standards Update (ASU) No. 2014-15 in August 2014 (Note 17). The ASU is in line with the principle that company management has the primary responsibility to evaluate whether or not the going concern basis of accounting is appropriate. The ASU gives company management guidance how to evaluate the continuity of the company and what to do and disclose when there is substantial doubt about the going concern ability within 12 months after issuance of the financial statements. Although in the 2013 exposure draft this period was even extended to 24 months after the financial statements date in order to give an early-warning disclosure, respondents considered the extended period too long and leading to limited informative value (FASB, 2014). Furthermore, the FASB has provided a definition of the important term 'substantial doubt' (Note 18). It is considered positive that such a core concept has been further defined, as this contributes to a more uniform evaluation of the so-called going concern assumption. If substantial doubt exists, company management has to consider its mitigating plans. If substantial doubt remains, this should be disclosed. ASU 2014-15 also requires disclosure when there was substantial doubt, but management's plans have alleviated this substantial doubt.

Finally, U.S. accounting standard ASC 855 *Subsequent events* requires disclosure in case of events after the reporting period due to which the so-called going concern assumption is no longer applicable, without adjusting the basis of accounting in the financial statements.

4.3 Auditing Rules

In this section the main findings whether or not the *auditing rules* provide an adequate basis for the *auditor* to audit and report on the (non) going concern basis of accounting are discussed.

4.3.1 International Standards on Auditing

The IAASB decided in 2015 to issue new and revised reporting-standards in the 700-series and also a revised standard 570 (IAASB, 2015e, 2016a) (Note 19). During and after the global economic crisis, stakeholders asked for an increased focus of both management and auditors on going concern matters (IAASB, 2015c). Using the results of academic research regarding users' perceptions of the financial statements and auditor's reporting (Asare & Wright, 2009; Gold et al., 2009; Mock et al., 2009; Porter et al., 2009), the IAASB wanted to enhance the communicative value and relevance of the auditor's report by revising its structure and content. Auditor's reporting on going concern has been explored as part of this project.

4.3.1.1 Standard 570 'Going Concern'

The first part of standard 570 'Going Concern' (paragraphs 3 to 7) describes the <u>responsibilities</u> of both management and auditor. This standard states that *management* should always assess the going concern abilities, even when not explicitly required by the applicable accounting standard. In our opinion, although being an *auditing* standard, starting with a description of *management's* responsibilities fits the call for a holistic approach regarding going concern. Besides the *auditor* has the responsibility to conclude on the appropriateness of the use of the going concern basis of accounting and whether a material uncertainty exists. Those responsibilities exist even if management according to the applicable accounting rules is not required to explicitly assess the entity's ability to continue as a going concern. In our opinion, this underpins the importance of a holistic approach of accounting and auditing standard setters. The description of the auditor's responsibilities contains a 'disclaimer' that the absence of a warning for material going concern uncertainties does not give a guarantee that the entity will continue as a going concern. Until the introduction of the *extended auditor's report*, stakeholders were probably not aware of the responsibilities of company management and the auditor and of this 'disclaimer' (Note 20).

The next part of standard 570 contains the <u>requirements</u> for the auditor with regard to going concern. The standard provides concrete examples of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. Some of those are rather obvious (*e.g. negative operating cash flows, inability to comply with the terms of loan agreements*), while others may be more surprising (*e.g. arrears or discontinuance of dividends, loss of key management without replacement*).
The auditor should evaluate the same period as management, with a minimum of 12 months from the date of the financial statements. If management has assessed a shorter period, the auditor should request management to extent the assessed period. In some circumstances, management's assessment can be rather high level but still sufficient. In other circumstances, the auditor has to evaluate management's assessment process, the assumptions used, plans for future actions and the feasibility of those plans.

In our opinion, standard 570 provides the auditor with pretty concrete guidance what to do '*to determine whether or not a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern*' (paragraph

16). The auditor must request management's assessment, evaluate plans and forecasts, consider additional facts or information and request written representations. Several audit procedures mentioned are also performed in the normal course of an audit (*e.g. analyzing and discussing cash flows, reading minutes for reference to financing difficulties*), while some others seem more specific (*e.g. assessing the financial ability of related and third parties to provide additional funds, obtaining written representations*). In concluding the audit, the auditor must evaluate the evidence and conclude whether or not the going concern basis of accounting is appropriate. Determining whether any uncertainty is material and any doubt is significant requires professional judgment. The auditor has to conclude on this regardless whether or how the applicable accounting standards define a material uncertainty. He also has to determine the adequacy of disclosures in the financial statements when events or conditions have been identified and a material uncertainty exists or no material uncertainty exists, including 'close call' situations. In requiring this, the auditing standard setter has enhanced the auditor's work effort in such specific situations (IAASB, 2015d).

Finally, the auditor must determine the potential consequences of his findings for the auditor's report. Although auditor's reporting is dealt with in the standards in the 700-series as discussed hereafter, standard 570 (paragraphs 21-24) also includes several requirements and explanations to auditor's reporting on going concern (see Table 2).

Table 2. Overview of potential consequences for the auditor's report

Paragraph	**Expectations**		**Adequate disclosure**	**Basis of accounting**	**Auditor's opinion**
	Mngt.	**Aud.**			
21/A26	+ or -	-	Yes/no	Going concern	Adverse
21/A27	-	-	Yes	Liquidation	Unmodified, probably emphasis of matter paragraph
22/A28-A31	?	?	Yes	Going concern	Unmodified, section 'Material uncertainty related to going concern'
23/A32-A33	?	?	No	Going concern	Qualified, adverse or disclaimer of opinion
24/A35	Management unwilling to make or extent its assessment			Going concern	Qualified or disclaimer of opinion

+ = positive, - = negative, ? = uncertain

In addition to the potential consequences for the auditor's report as included in Table 2, the auditor may also communicate matters relating to going concern as a key audit matter in his report as will be discussed hereafter. Furthermore, the auditor can provide an explanation of the auditor's report and the audit procedures performed during the general meeting of shareholders (e.g. NBA, 2018b). Finally, the auditor may also be required to communicate (not publicly) with those charged with governance about going concern uncertainties.

4.3.1.2 Standards 700-Series 'Auditor's Report'

In the period from 2006 till the end of 2016, the auditor's report has been revised significantly, including changes that are also relevant in the context of going concern reporting. With the new and revised standards in the 700-series and a revised standard 570, the new *extended auditor's report* has been introduced for all audits with some specific provisions for PIEs. According to Köhler, Quick and Willekens (2016), the introduction of the extended auditor's report is probably the major innovation in auditing regulation in recent years.

Before the introduction of the extended auditor's report, the auditor's report only mentioned going concern (issues) if the auditor added an emphasis of matter paragraph regarding going concern uncertainty or if he modified his opinion due to going concern issues that were not adequately accounted for in the financial statements. An emphasis of matter paragraph actually consisted of two sentences of mainly boilerplate texts. The first sentence referred to the financial statements (Note 21). The second sentence stated that the auditor's opinion is not qualified, because it's an emphasis of matter paragraph and not a basis for a qualified opinion. At that time, the auditor's report did not mention the responsibilities of the auditor and management regarding going concern (issues). Not communicating those responsibilities probably could influence the expectations gap between the auditor and the stakeholders because stakeholders could have different expectations of the responsibilities of the auditor compared to what the auditing standards require.

With the introduction of the extended auditor's report, the responsibilities regarding going concern of both company management (paragraph ISA 700.33(b)) and the auditor (paragraph 700.38(b) (iv)) have to be mentioned in each auditor's report. We agree with the IAASB (IAASB, 2015d) that this could have an educational value, could be helpful to address the expectations gap and could increase the focus on going concern (Note 22). It is remarkable however that for mentioning the auditor's responsibilities three options are allowed (paragraph 700.40): (1) in the main text of the auditor's report, (2) in an appendix to the auditor's report or (3) via a reference in the auditor's report to a website of an appropriate authority. The second and third option should contribute to the reduction of standardized language in the auditor's report (IAASB, 2015d). In order to enhance the attention to going concern and to clearly communicate the responsibilities of the different parties, however, we would prefer the first option. Based on a survey research, Bozinovska Lazarevska and Serafimoska Trpeska (2016) also conclude that auditors prefer inclusion in the main text. Reviewing comment letters regarding the IAASB proposals, Cordoş and Fülöp (2015b) report similar results. Based on a review of 165 stakeholder responses to the IAASB's 2012 Invitation to Comment, however, Simnett and Huggins (2014) report strong support for such

descriptions of management's and auditor's responsibilities, but also that a majority of the respondents (in particular users and preparers) supported the second and third option. We encourage further academic research into the actual effects of mentioning the responsibilities of both management and auditor and the potentially different effects of the three options allowed regarding auditor's responsibilities.

The new ISA 701 *Communicating key audit matters in the independent auditor's report* has introduced a new section into the extended auditor's report, mandatory but not limited to audits of the financial statements of listed entities/PIEs. The auditor should provide an entity-specific description of a key audit matter (referring to the disclosures in the financial statements), why it is a key audit matter and how it is addressed. The purpose is '*to enhance the communicative value of the auditor's report by providing greater transparency about the audit that was performed*' (paragraph 701.2), thereby improving the quality of the audit and financial reporting and reducing the expectations gap (IAASB, 2015d). During the consultation process, arguments of proponents have outweighed arguments of opponents that for example key audit matters could blur responsibilities, undermine the opinion on the financial statements as a whole, trigger a negative reaction and result in an information overload. In an exploratory study on the introduction of key audit matters, Segal (2017) also emphasizes the risks of disclosing confidential information about going concern and the use of boilerplate wording.

Although a going concern issue by its nature is a key audit matter (paragraph 701.15), a key audit matter '*is not a substitute for reporting in accordance with ISA 570 when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern*' (paragraph 701.4(c)). In such circumstances, the 'Key audit matters' section should (only) refer to the section 'Material uncertainty related to going concern' (paragraph 701.15). But it is also possible that, although in the end no material uncertainty regarding going concern exists, the auditor concludes that he has to report on his work effort in this respect as a key audit matter (paragraph 701.A41). This also fits the call for more insight into 'close call' situations (IAASB, 2015d). Before the introduction of the extended auditor's report, situations as included in a 'key audit matter'-paragraph would not end up in the auditor's report (IAASB, 2015a, 2015b). In our opinion, the inclusion of a key audit matter addressing going concern contributes to the informative value of the auditor's reporting on going concern.

Prior academic research regarding the use of the newly introduced key audit matters is mostly based on experiments, surveys and a review of comment letters, although some studies already use archival data. This prior research is not specifically focused on going concern related key audit matters and shows mixed results (e.g. Bédard, Coram, Espahbodi, & Mock, 2016; Boolaky & Quick, 2016; Bozinovska Lazarevska & Serafimoska Trpeska, 2016; Christensen, Glover, & Wolfe, 2014; Cordoş & Fülöp, 2015b; Evers, Van Buuren, & Van Nieuw Amerongen, 2019; Gold & Heilmann, 2019; Masdor & Shamsuddin, 2018; Sirois, Bédard, & Bera, 2018; Trpeska, Atanasovski, & Bozinovska Lazarevska, 2017). According to a review study by Masdor and Shamsuddin (2018), going concern issues are not in the top 4 of reported key audit matters. We suggest further academic research into the actual use of key

audit matters to address going concern in order to examine whether and how they are used in practice to report on going concern.

The next relevant standard that has been revised is standard 706 *Emphasis of matter paragraphs and other matter paragraphs in the independent auditor's report*. Previously, an 'emphasis of matter paragraph' has often been used to report material going concern uncertainties, whereas with the new and revised standards a specific paragraph 'Material uncertainty related to going concern' is introduced to give it more prominence. Based on the illustrative text as included in the appendix to ISA 570, we note that the content of this section still has many similarities with the 'emphasis of matter paragraph' as previously expressed. Therefore, we consider the introduction of this heading mainly as a cosmetic adjustment. Based on a survey study, Trpeska, Atanasovski, and Bozinovska Lazarevska (2017) find that loan officers consider information about a material uncertainty related to going concern as highly important, however with a rating similar to the rating given to the emphasis of matter paragraph as included in the previous auditor's report format.

4.3.2 European and Dutch Auditing Rules (Note 23)

Based on Directive 2014/56/EU, the ISAs discussed are also applicable within the EU. The parts of this Directive that explicitly refer to reporting on going concern (articles 25a and 28) are also included in these auditing standards. Regulation (EU) No 537/2014 sets further rules to audits of PIEs, because of their public relevance. Article 10 introduces some elements of an extended auditor's report, including reporting on 'key audit matters'. Article 11 requires an additional (not publicly) report of the auditor to the audit committee of a PIE, including reporting on applicable going concern issues. Furthermore, article 12 paragraph 1b requires the auditor to report (not publicly) to the supervisory authority '*a material threat or doubt concerning the continuous functioning of the public-interest entity*'.

For periods ending on or after 15 December 2014 and before the introduction of the new and revised ISAs (applicable as of 15 December 2016), the auditors of Dutch PIEs had to comply with the temporary Dutch standard 702N *Additions to reporting on a complete set of financial statements for general purposes of a public-interest entity* (Note 24). This standard was based on the 2014-draft version of the ISAs, elements of article 10 of Regulation (EU) No 537/2014, specific Dutch elements and developments in the United Kingdom (paragraph 702N.3). Regarding *going concern*, the implemented changes are comparable with the new and revised ISAs, despite some marginal differences in wording used to describe management's responsibilities.

4.3.3 U.S. GAAS

U.S. *auditing* standards already pay attention to continuity for some time. Where Statement on Auditing Standard (SAS) 34 *The auditor's considerations when a question arises about an entity's continued existence* (issued in 1981) asked for a passive approach, this changed with SAS 59 *The auditor's consideration of an entity's ability to continue as a going concern* (issued in 1988) into an active approach (e.g. Bellovary, Giacomino, & Akers, 2006). Thereafter, both U.S. auditing standard setters chose their own way.

In 2012 the American Institute of Certified Public Accountants (AICPA; standards apply to the audit of non-public companies) drafted SAS 126 *The auditor's consideration of an entity's ability to continue as a going concern* to replace SAS 59. There was, however, still no convergence with international standards. This changed when SAS 126 was replaced by SAS 132 *The auditor's consideration of an entity's ability to continue as a going concern* (effective date: audits of financial statements ending on or after 15 December 2017; AICPA, 2017b). In drafting SAS 132, the AICPA has explicitly sought harmonization and convergence with the FASB accounting standard ASU 2014-15 and ISA 570 (AICPA, 2016). But some differences remain due to the fact the AICPA's auditor's reporting project was still ongoing when SAS 132 became effective, while ISA 570 was amended simultaneously with the introduction of the extended auditor's report. For example, SAS 132 still requires an emphasis of matter paragraph and uses terminology that matches the U.S. accounting standards, but differs from the ISAs.

Probably (part of) those differences will be removed as a result of the AICPA's proposals to amend the standards on auditor's reporting (expected effective date: audits of financial statements ending on or after 15 June 2019; AICPA, 2017a). These proposals are more in line with the new ISAs and include for example: a) communication of key audit matters, b) expanded description of responsibilities, and c) a separate section 'Substantial doubt about the entity's ability to continue as a going concern' instead of an emphasis of matter paragraph. Some differences however remain, for example in the wording of the responsibilities regarding going concern. In particular the description of the auditor's responsibilities in the AICPA's proposal is much more concise, which, in our opinion, provides less insight.

The Public Company Accounting Oversight Board (PCAOB; standards apply to the audit of public companies) has followed a different route and has codified SAS 59 into AU-section 341 *Consideration of an entity's ability to continue as a going concern*, which subsequently has been reorganized as Auditing Standard (AS) 2415 (effective as of 31 December 2016). As a result, the current PCAOB-standard on going concern has remained almost unchanged since 1988.

But the PCAOB has also issued a new standard AS 3101 *The auditor's report on an audit of financial statements when the auditor expresses an unqualified opinion* and amended some other standards (Note 25). In drafting the new standard, the PCAOB has taken international developments into account (PCAOB, 2017), for example resulting in the introduction of critical audit matters. However, where in an IAASB-based auditor's report a material uncertainty related to going concern is reported in a section 'Material uncertainty related to going concern' and not reported as a key audit matter, in a PCAOB-based auditor's report both an explanatory paragraph and a critical audit matter would be required (cross-reference allowed) (IAASB, 2017). Moreover, the new PCAOB-based auditor's report is less extended and for example does not include a description of both management's and auditor's responsibilities regarding going concern (IAASB, 2016b). Main reason for not including such descriptions was the perceived risk of boilerplate texts and the little interest from investors in such texts. Furthermore, the PCAOB's standard on going concern AS 2415 has been amended just slightly. The main change is that the explanatory paragraph – to report substantial doubt

about an entity's ability to continue as a going concern – should include an appropriate title and immediately follow the opinion paragraph.

5. Discussion and Conclusions

Based on the research findings, we conclude that several changes in the regulatory framework have been made that could contribute to more accurate and informative reporting on going concern. These changes include an increased focus on substantiated reporting on long-term value creation and continuity by company management (U.K. and Dutch *corporate governance codes*), increased attention to reporting on going concern (Dutch and U.S. *accounting standards*), the requirement to state the responsibilities of both management and the auditor in every auditor's report and the introduction of key audit matters offering the possibility to report on going concern risks and the audit procedures performed (Dutch, international and (partly) U.S. *auditing standards*). It also can be concluded however, that the rules show international differences.

From a cross-sectional perspective, we reason that the auditing rules regarding going concern provide more guidance and appear to place higher demands on the auditor compared to the guidance and requirements as included in the accounting standards. This situation seems undesirable, as company management is first to report in the financial statements, after which the auditor audits these financial statements and reports the results thereof in his auditor's report. This situation is due to different standard setters seemingly following their own route and own pace, instead of working together along the lines of a holistic approach. Such a holistic approach should ensure the responsibilities of company management and the auditor are aligned, in our expectation resulting in improved reporting on going concern. In the current situation however, there is no international convergence and the responsibilities of company management and the auditor are not fully aligned.

The lack of a holistic approach may also have contributed to the rejection of several more progressive proposals to change the existing rules and regulations as discussed. Examples of such proposals include a continuity statement (not implemented in the Dutch corporate governance code) and further clarification and disclosure requirements (not implemented in the international accounting standards). Maybe the most progressive proposal was to include in every auditor's report a conclusion on the appropriateness of the use of the going concern basis of accounting and a statement whether or not a material uncertainty has been identified that may cast significant doubt on the entity's ability to continue as a going concern (IAASB, 2013). In our opinion, such a reporting model might contribute to an improvement of the accuracy of the auditor's reporting on going concern. This proposal, however, also did not make it in the end (Note 26).

Partly due to the non-implementation of some of these more progressive proposals, we conclude that there is still mainly an exception-based reporting model regarding going concern (Note 27). This is particularly visible in the accounting rules and – besides the mentioning of the responsibilities regarding going concern – also in the auditing rules. Although we understand some of the arguments of the proponents of an exception-based reporting model, in our opinion an exception-based reporting model has several

disadvantages. Sticking to such a model could result in limited attention to going concern (issues) in preparing and auditing the financial statements. Furthermore, it could also raise a threshold to warn for going concern issues if applicable, since both company management and the auditor normally do not report about going concern (issues) with the increased risk that in case they do report, this quickly gets a (too) negative load. But in order to be able to transfer the existing exception-based reporting model into a model in which both company management and the auditor always report on the continuity of a company, in our opinion it is crucial that the standard setters work together along the lines of a holistic approach and further align the responsibilities of company management and the auditor.

Based on our research, our conclusions are ambiguous. On the one hand, we conclude that from a theoretical viewpoint, recent changes in the regulatory framework regarding accounting and auditing could contribute to an adequate basis for both company management and the auditor to report (accurately and informatively) on going concern. However, the recent changes do not outweigh the disadvantages that still exist and result in retaining an exception-based reporting model, where in our opinion a holistic approach is needed to further enhance the accuracy and informative value of reporting on going concern. Besides, more convergence in rules and legislation regarding reporting on going concern is still possible. Finally, we suggest further academic research to examine the actual effects of the changes in rules and legislation regarding going concern reporting.

As with all research of this type, some limitations exist. Several positions as expressed in this study are our subjective viewpoints. Furthermore, this study concerns an analysis of a dynamic regulatory framework and we expect that the rules and legislation regarding going concern reporting will continue to change in the future (Note 28), offering opportunities for further research.

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Notes

Note 1. Prior research shows that by far most auditor's reports are unmodified (e.g. Xu et al., 2013).

Note 2. The accuracy of auditor's reporting on going concern is determined by the question whether the auditor (properly) gives or does not give a warning signal to a subsequently (non-)viable client. The informativeness or informative value of auditor's reporting on going concern could be analyzed in different ways, such as by analyzing the wording used to report on going concern or by measuring the market reaction after the issuance of a going concern report.

Note 3. We note that – prior to the introduction of the extended auditor's report – going

concern (issues) were only mentioned in an emphasis of matter paragraph or if the auditor modified his opinion. Such a paragraph or modified opinion consisted of short standard (mainly boilerplate) text.

Note 4. This while the going concern assumption is '*one of the most fundamental accounting assumptions*' (e.g. Trainor, Phillips, & Cangialosi, 2018, p. 17).

Note 5. Or as stated by Church et al. (2008, p. 75): '*The audit process is inextricably linked to accounting standards.*'

Note 6. According to the Cambridge Dictionary, holistic means '*dealing with or treating the whole of something or someone and not just a part.*'

Note 7. Status of the regulatory framework as at 1 January 2018.

Note 8. In the light of international convergence, it is remarkable that in June 2017 the governing bodies of the corporate governance codes in the United Kingdom, Germany, France, Italy and the Netherlands emphasized the importance of national corporate governance codes. See: https://www.mccg.nl/nieuws/5717/Gezamenlijke-verklaring-Five-Chairmen-Group. Given their position, it is not surprising that there is no EU Code.

Note 9. 88 out of 107 responses are published on the website http://www.mccg.nl/?page=5405. The remaining 19 respondents have indicated that they do not appreciate publication of their response.

Note 10. In Dutch: 'Nederlandse Beroepsorganisatie van Accountants' (NBA).

Note 11. Because the scope of this study is limited to companies with a mandatory audit, this discussion will also be limited to the main points of those rules for medium sized and large companies.

Note 12. The foundation of reporting by Dutch medium sized and large companies can be found in Part 9, Book 2 of the Dutch Civil Code (in Dutch: 'Burgerlijk Wetboek') and in the Dutch Accounting Standards (in Dutch: 'Richtlijnen voor de jaarverslaggeving voor middelgrote en grote rechtspersonen'). For the purpose of harmonization of the European accounting law, several European Directives have been incorporated into Dutch Law. For example the Fourth Council Directive 78/660/EEC and the Seventh Council Directive 83/349/EEC, both superseded by European Directive 2013/34/EU.

Note 13. http://wetten.overheid.nl/BWBR0003045/2017-09-01/0/Boek2/Titeldeel9/Afdeling6/Artikel384/informatie#Wijzigingen.

Note 14. Although these accounting standards do not have the status of a legal provision and therefore are not binding, in jurisprudence they are called '*the authoritative source of knowledge of standards to be considered*' (Deloitte, 2018, p. 16).

Note 15. This standard does not apply to situations of termination of part of the business activities.

Note 16. Standard 170 was included for the first time in the 2010-edition of the Dutch

Accounting Standards, so after the start of the global economic crisis in 2007.

Note 17. ASU No. 2014-15 *Presentation of financial statements – Going concern (Subtopic 205-40): Disclosure of uncertainties about an entity's ability to continue as a going concern*, effective for periods ending after 15 December 2016 with earlier application permitted. This ASU has been codified in ASC 205-40.

Note 18. Ittonen, Tronnes, and Wong (2017) have examined the substantial doubt threshold, reporting a 0.08 probability of bankruptcy as a threshold resulting in the highest information value of going concern modified auditor's reports, where others report significantly higher thresholds.

Note 19. Effective for the audit of financial statements for periods ending on or after 15 December 2016.

Note 20. Cordoş and Fülöp (2015a) report that most respondents to the Exposure Draft disagreed with the inclusion of such a statement. Asare and Wright (2012) report that auditors, investors and bankers give a mean score of 5.05 (maximum of 7.00) to the level of confidence on a company's future viability provided by a standard auditor's report. Gray et al. (2011) report that in case the auditor's report does not mention going concern, users believe the auditor has tested this issue 'thoroughly' and no problem has been identified.

Note 21. Prior experimental research by Anandarajan, Viger, and Curatola (2002) shows that inclusion of such a paragraph in the auditor's report with a reference to the (stand-alone) note in the financial statements provides incremental informative value above only a (stand-alone) note in the financial statements. Based on a research synthesis, however, Mock et al. (2013) report the absence of a market reaction once the going concern issue is disclosed in a note in the financial statements.

Note 22. Based on an experiment, Gold et al. (2012) report that additional explanation of management's and auditor's responsibilities does not reduce the expectations gap. Their study, however, was based on a previous version of ISA 700, including limited descriptions of responsibilities compared to the 2016-version of ISA 700, and a specific description of responsibilities regarding going concern was lacking.

Note 23. The EU audit legislation as issued in 2014 should be applied from 17 June 2016. The member states have over 50 member state options and earlier adoption is allowed.

Note 24. The accelerated introduction of the extended auditor's report in the Netherlands is motivated by the fact that the NBA thereby implements one of the measures as included in the reform report 'In the public interest' to restore public trust in the audit profession (NBA, 2014a, 2014b).

Note 25. Effective date: audit of financial statements ending on or after 15 December 2017; 'critical audit matters' in 2019/2020.

Note 26. Opponents argued that the proposal for example would imply a different level of assurance regarding going concern, result in a too high level of comfort regarding going

concern, give too much attention to the going concern assumption, represent a so-called ‘piecemeal opinion’ and probably result in boilerplate language (IAASB, 2015d). See also Cordoş and Fülöp (2015a), showing mixed results based on a content analysis of European comment letters regarding this proposal. Simnett and Huggins (2014) also show mixed results based on a content analysis of 165 responses of stakeholders to the initial IAASB’s 2012 Invitation to Comment.

Note 27. In an exception-based reporting model, ‘*reporting on a material uncertainty related to going concern would be limited to situations when it is determined that a material uncertainty exists related to events or conditions that cast significant doubt on the entity’s ability to continue as a going concern*’ (IAASB, 2015d, p. 28).

Note 28. See for example the call of the NBA in a white paper regarding continuity (NBA, 2018d).

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