Safe Bank 2 (71) 2018

DOI: 10.26354/bb.8.2.71.2018

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Should Creditors Believe in Auditors' Opinions? Auditors' Independence, Going-Concern Warnings and Credit Risk Assessment

Abstract

Credit risk assessment is an inherent component of banking activity and it is crucial to analyse time aspect of credit risk. During that assessment banks ought to use only reliable documents to achieve reasonable results. Financial statements should not be the one and only data source support loan decision but they are indispensable.

This study is a part of research trend assessing auditors' independence. The purpose of it was twofold. Firstly, to determine if there exists significant dependence between business continuity evidenced by bankruptcies and going-concern warnings paragraphs (GCW) in auditors' opinion. Secondly, to examine possible interrelation of existence GCW in auditors' opinion and non-audit fees earned by these auditors. The research question for this paper is whether banks and other creditors may still base on financial statements and auditor's opinions. To the limitation that the aim of this paper was not to give clear answer which measure of going-concern risk is most appropriate, it presents outcomes of an investigation of a sample of companies quoted on Warsaw Stock Exchange (Poland) main market, that submitted request for bankruptcy to the court register between January 1, 2009 and December 31, 2013.

Key words: audit opinion, going-concern, credit risk, financial statement quality, disclosures

1. Introduction

Credit risk assessment is an inherent component of banking activity and it is crucial to analyse time aspect of credit risk. Of course, none delay in repayment of instalments is welcome, but it is great difference whether such delay is a matter of some technical or organisational problems of debtor or maybe it is a matter of

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structural inability to repay a loan[1]. Therefore, it is essential to use only reliable documents during the process of credit risk evaluation to achieve a satisfying answer. One of the most important sources of information useful in this procedure are undoubtedly year-end financial statements. But to achieve a reasonable base for taking loan decision one need to believe in information included in financial statement, because most of ratios and indicators are based on data from these reports. Financial statements present historical figures and should not be the one and only data source that supports making loan decision but they are still indispensable when deciding about granting the loans.

An independent auditor's opinion is perceived as an institutional confirmation that information disclosed in financial statement present **truth**. But, to be precise in practice according to Polish act on Statutory Auditors, Audit Firms and Public Oversight the opinion states whether "the financial statement gives a **true and fair view** of assets and financial position, as well as the financial result of the audited entity, in accordance with applicable accounting and financial reporting regulations, as well as adopted accounting principles (policy)"[2]. Despite the very similar wording of these two terms (truth and true and fair view) their semantic content is different[3]. Moreover, the auditors' independence has been repeatedly questioned as there exists plenty of research showing that the increase in scope of auditors' fees received for delivering non-audit services, such as (aggressive) tax planning, business consulting or other advisory services erode auditors' objectivity[4]. Such cross-selling of services, which in author opinion is even more evident in Big 4 firms case, may reduce auditors' vigilance and willingness to inform about the problems of business continuity (going-concern) of financial statement preparers. The point is that such extended companies like Big 4 are particularly tempted to provide additional services in order to maintain non-audit departments. Thereby, there is

1 R. Kałużny, *Pomiar ryzyka kredytowego banku: aspekty finansowe i rachunkowe*, Wydawnictwo Naukowe PWN, Warszawa 2009, pp. 29–30.

2 Ustawa z dnia 11.05.2017 roku o biegłych rewidentach, firmach audytorskich oraz nadzorze publicznym, Dz. U. z 2017 r. poz. 1089 ze zm.

3 N.E. Kirk, *'True and Fair View' versus 'Present Fairly in Conformity with Generally Accepted Accounting Principles*, Massey University School of Accountancy, Discussion Paper Series 208, 2001; C. Metzker, *The truth, the who truth and nothing but the truth in financial reporting*, AFP Exchange; Bethesda Tom 23, No. 1, 2003, pp. 56–58; M. Bayou, A. Reinstein, P. Williams, *To tell the truth: A discussion of issues concerning truth and ethics in accounting*, Accounting, Organizations and Society 36, 2011, pp. 109–124; R. Kałużny, A. Piechocka-Kałużna, *Censoring as an aspect of truth in financial statements of insurance companies. Case of Poland*, 2018, the paper under publication.

4 G. Wines, *Auditor independence, audit qualifications and the provision of non-audit services: A note*. Accounting and Finance Vol. 34 (1), 1994, pp. 75–86; D. Lowe, K. Pany, *An examination of the effects of type of engagements, materiality, and structure on CPA consulting engagements with audit clients*, Accounting Horizon, Vol. 10(4), 1996, pp 32–52; D. Sharma, J. Sidhu, *Professionalism vs commercialism: The association between non-audit services (NAS) and audit independence*, Journal of Business Finance & Accounting, June/July 2001, pp. 595–629; V. Beattie, S. Fearnley, *Auditor Independence and Non-Audit Services: A Literature Review*, Institute of Chartered Accountants and Wales, 2002; A. Schneider, B. Church, K. Ely, *Non-audit Services and the Auditor Independence: A Review of the Literature*, Journal of Accounting Literature, Vol. 25, 2006, pp. 169–211; E. Austin, S. Herath, *Auditor independence: a review of literature*, International Journal of Economics and Accounting, Vol. 5, No. 1, 2014, pp. 62–74.

a potential risk of kind of soft audit so as to achieve the highest overall revenues from serving a client. The review of researches conducted before and after last financial crisis (2007) and period of large accounting scandals (2000–2001) justify the adoption of such assumptions.

If one can prove such causal relationship between delivering non-audit services and quality deterioration of auditor's opinion (especially in its paragraph relates to going-concern assumption), both financial statement and auditor's opinion are not useful anymore for the credit risk purposes.

Financial statements are closely linked to decision making process since according to accounting theory accounting itself is usually defined as the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by users of the information[5]. The role of financial reporting (which is a part of accounting), is to provide information that is useful in making business and economic decisions[6]. According to International Financial Reporting Standards (IFRS) which are mandatory (with minor limitations) for the companies quoted within European Union "the objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity"[7].

There is a recommendation that all professionals must convince the public that their work will be efficacious and honourable[8]. The traditional audit has often been described as a public interest service[9]. It may even be called as some kind of social agreement between auditors and the rest of society. The reason of such special status is that external auditor's services are a helpful tool in reducing agency costs[10]. Therefore, the independence of auditors should be the hallmark of profession[11]. Consequently, auditors are obliged to have systems in place that are likely to deliver high-quality engagements and manageable degrees of moral hazard. Different groups of stakeholders' perceptions may be impacted by whether the independent auditors' report accompanying the financial information is unqualified or contains a going-concern modification[12] since clean audit report

5 E. Hendriksen, M. van Breda, *Accounting theory. 5th Edition*, Irwin, 1992.

6 Financial Accounting Standards Board, Statement of Financial Accounting Concepts No. 1, '*Objectives of Financial Reporting by Business Enterprises*', 1978.

7 International Accounting Standards Board, *The Conceptual Framework for Financial Reporting*, 2010.

8 A. Abbott, *The System of Professions*, University of Chicago Press, Chicago IL, 1988.

9 R. Mautz, H. Sharaf, *The Philosophy of Auditing*, American Accounting Association, Sarasota, FL, 1961; T. Lee, *Corporate Audit Theory*, Chapman & Hall, New York, NY, 1993; D. Flint, *Philosophy and Principles of Auditing – An Introduction*, Macmillan, London 1988.

10 M. Jensen, W. Meckling, *Theory of the firm: managerial behavior, agency costs, and ownership structure*, Journal of Financial Economics 3, 1976, pp. 305–360.

11 S. Ference, *Independence is in the eye of the beholder*, Journal of Accountancy, June 2013.

12 B. Foster and T. Shastri, *Determinants of going concern opinions and audit fees for development stage enterprises*, Advances in Accounting, incorporating Advances in International Accounting, Vol. 33, 2016, pp. 69.

increases the likelihood obtaining funding and often reduces the amount of additional information entrepreneurs must provide to obtain financing for example from lenders. But audits are nothing if they do not possess the confidence of those that read the audit opinion[13]. However, public interest dimensions of the modern audit require a consideration of the balance between the audit and other services like for example consulting. And that is an issue stimulating ongoing question about auditor's independence in sense of lack of bias in forming their professional judgments stated subsequently in their opinions. That is because being independent in this context means 'independence in appearance', which may be threatened when auditors are in close relationship to their clients. Contrary, 'independence in fact' which means meeting formal requirements implemented to appropriate legal acts. Independence itself is not defined as just compliance with the independence rules[14]. Such dimension is in line to accepted definition of independence, which concentrates on freedom from those factors that compromise, or can reasonably be expected to compromise, an auditor's ability to make unbiased audit decisions[15].

Whether or not the provision of consulting service to audit clients erodes the independence of the audit has been keenly debated since the 1970s because of its growing importance to the firms as a revenue source[16]. One may even say that service provided by audit firms is no longer auditing, that is just pure consulting (which is not so independent as audit). Therefore, the quality of auditor's opinion is not perceived in the eyes of opinion's user because economic dependence on clients' fees strongly affect auditor's independence. Non-audit services deliver extra revenues to audit firms but they also might engender an unhealthy degree of economic dependence between the auditing and client firms. Specifically, the auditing firm might lose sight of its obligation to cast a critical eye on its clients' accounting practices for fear of losing such a lucrative revenue source. Moreover, there might arise a conflict of interests, as in the consulting role the auditor's client is management and not the shareholders[17]. Summarising, both over-dependence on fees received from one source (one client) and provisioning for non-audit services delivered to audited client are potential threats that may influent on auditor's independence. Such environment frameworks justified existence of public regulator, whose aim should be protecting value of audits and ensuring that auditors meet

[13] T. Fogarty, J. Rigsby, *A reflective analysis of the "new audit" and the public interest: The revolutionary innovation that never came*, Journal of Accounting & Organizational Change, Vol. 6, Iss 3, 2010, pp. 300–329.

[14] S. Mcgrath, A. Siegel, T. Dunfee, A. Glazer, H. Jaenicke, *A Framework for Auditor Independence*, Journal of Accountancy, January 2001.

[15] International Federation of Accountants, *International Standard on Auditing 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, 2009.

[16] T. Fogarty, J. Rigsby, *A reflective analysis of the "new audit" and the public interest: The revolutionary innovation that never came*, Journal of Accounting & Organizational Change, Vol. 6, Iss 3, 2010, pp. 300–329.

[17] R. Iyengar, E. Zampelli, *Auditor independence, executive pay and firm performance*, Accounting and Finance, 48 (2008), pp. 259–278.

quality and independence criteria[18]. But even knowing that public regulator is vital to financial statement users (including investors), for whom audit process seems to be something oversophisticated similar to black box, there is still actual question of regulator's activity effectiveness. Of course, there are some incentives that motivate auditors to deliver thorough services. The most important are avoiding costs of potential litigation and preserving reputation[19].

Taking into consideration such essential questions about auditor's independence, users of financial statements may come to the conclusion that auditor's quality (which equals to opinion's value) is not at the same level anymore. Therefore, users of financial reports and auditors' opinions, especially professionals (such as banks and other creditors) are entitled to doubt their veracity[20]. Moreover, following this line of thought banks and creditors should be more prudent while taking loan decisions, because of likely going-concern problems of potential debtors.

Using audit opinions and financial statements as the most irrefutable source of information about debtor financial standing seems to be groundless. Although auditors do not opine on a client's creditworthiness, they are required to report if there is doubt as to a client's ability to continue as a going-concern[21]. Going-concern assumption means ability to continuance business for a foreseeable future. Financial statements are prepared on a going concern basis, unless management either intends to liquidate the entity or to cease operations or has no realistic alternative but to do so[22].

According to International Audit Standards[23] that is management role to prove appropriateness of going-concern assumption, but auditor's role is evaluating management assessment. In practice there may occur different scenarios. (1) If going-concern assumption is proper but material uncertainty exists and company disclosed it the auditor should consider additional paragraph (which is not modification of an opinion) named emphasis of matter to highlight such uncertainty. However, (2) if there is no disclosure about material uncertainty, auditor should express a qualified or adverse opinion. (3) If company applied going-concern

[18] D. Aobdia, N. Shroff, *Regulatory Oversight and Auditor Market Share*, Journal of Accounting & Economics (JAE), Vol. 63, No. 2, 2017, pp. 262–287.

[19] For example R. Dye, *Auditing standards, legal liability, and auditor wealth*, Journal of Political Economy 101 (5), 1993, pp. 887–914 or D. Simunic, *The pricing of audit services: Theory and evidence*, Journal of Accounting Research, Vol. 18, No. 1, 1980, pp. 161–190.

[20] T. Tagesson, P. Öhman, *To be or not to be – auditors' ability to signal going concern problems*, Journal of Accounting & Organizational Change, Vol. 11, Iss 2, 2015, pp. 175–192; D. Feldmann, W. Read, *Going--concern audit opinions for bankrupt companies – impact of credit rating*, Managerial Auditing Journal, Vol. 28 Iss 4, 2013, pp. 345–363.

[21] D. Feldmann, W. Read, *Going-concern audit opinions for bankrupt companies – impact of credit rating*, Managerial Auditing Journal, Vol. 28, Iss 4, 2013, pp. 345–363; International Federation of Accountants, *International Standard on Auditing 570, Going Concern*, 2009.

[22] International Federation of Accountants, *International Standard on Auditing 570, Going Concern*, 2009.

[23] International Federation of Accountants, *International Standard on Auditing 570, Going Concern*, 2009.

assumption which in auditor opinion is not proper, he / she ought to express adverse opinion. (4) If there exist several material uncertainties to the financial statement as a whole, or (5) if management is unwilling to extend its going-concern assessment auditor should express disclaimer of opinion[24].

There is an auditor's assessment whether in particular situation an opinion should contain emphasis of matter, or maybe financial statement should receive a qualified opinion, an adverse opinion or even disclaimer of opinion. Otherwise, if in auditor's opinion going concern assumption is evaluated and disclosed properly by the preparer of financial statement, an auditor's opinion does not have to address that issue[25]. Bearing in mind potential decline in opinions' quality there is threat of going-concern warning omission.

As a result, audit opinions' users may lose (so far) useful tool for ascertain imminent bankruptcy of banks' clients. Especially, when there is a discussion whether auditors' going-concern opinions are more effective than other bankruptcy prediction models. Being predictor of possible troubles is not a role of external auditor. However, auditors' opinions users treat his appraisal of audited entity resulting going-concern paragraph in auditors' opinion as an early warning signal. Even if several studies proved that only in half the cases where companies ultimately went bankrupt was a going concern opinion ever issued before their filing for bankruptcy[26].

The problem of auditor's role in not new because existence of 'expectations gap' between assurance provided in audit opinion and expectations of financial statements' users is well documented in prior researches[27]. The reason of occurring the gap is misunderstanding the role of financial audit (and therefore the role of auditor engaged in particular audit) leading to establishing expectations far beyond obligations imposed on auditors.

This paper aims to investigate the relationship between audit opinion and continuity problems of potential debtors. It is reasonable to assume that audit opinions, prepared by professionals having access to all evidence within the company, should contain required disclosures about all potential problems including going-concern problems. Namely, going-concern warning paragraphs in the opinions. There are several harbingers of potential business continuity troubles including negative equity and large net loss for the year. Although not every company recording negative equity disappears from the market, the existence of liabilities bigger than assets is not welcome. Furthermore, according to Polish legal framework, in particular

[24] International Federation of Accountants, *International Standard on Auditing 570, Going Concern*, 2009.

[25] *Ibidem*.

[26] P. Cybinski, C. Windsor, *The Efficacy of Auditors' Going-Concern Opinions Compared with a Temporal and an Atemporal Bankruptcy Risk Model: Analysing U.S Trade and Service Industry Failures 1974–1988*, Pacific Accounting Review – Vol. 17, No. 1, 2004, pp. 3–36.

[27] For example D. Guy, J. Sullivan, *The Expectation Gap Auditing Standards*, Journal of Accountancy, Vol. 165, Issue 4, 1998, pp. 36–46.

Bankruptcy Law[28], such relationship between liabilities and assets imposed an obligation on the management board to submit request for bankruptcy to the court register. Other potential warning signal is a significant loss (which I defined as 50% of company's equity) since it is almost similar to measure applied in Polish Commercial Companies Code[29] as a reason for adoption an owners' resolution on further existence of a company.

To achieve that goal I designed several phases of my research. First, I studied whether an auditor supported its client by providing additional consulting services. Second, I investigated if there was significant deterioration of financial standing of auditor's client in subsequent periods. Third, I ascertained whether an auditor in its opinion discloses appropriate information about potential going concern problems. The next section of this paper develops the hypotheses to be tested. Sections three and four discuss the method and results, respectively. The final section summarizes the work, discusses the implications, and suggests directions for future research.

2. Auditor accuracy, independence and its influence on going-concern warnings

Delivering true and fair view, an entity standing and its possibility for continuing its activity (or risk of near default) is pointed to be one of the reasons of preparing financial statements. Since financial statements' external audit is identified to achieve such true and fair view of an entity, the most important part of an audit work is just stating warnings related to ability for going-concern. In practice, there are two facets of audit work before stating going-concern warnings in auditor's opinion. First step is investigation whether an audited entity did ever implement any procedures to appraise its ability to continue doing business. In second step, auditor ought to check if financial statement reflects effect of these procedures and inform on likelihood of future dire straits. Then auditor warns (via going-concern warnings in opinion) financial statement's users about material derogations in these procedures issuing qualifying or adverse opinion or even disclaimer of opinion. Alternatively, if an entity is in danger of fail and it reports it, the auditor expresses the risk of default that is disclosed in audited financial statement by including emphasis of matter in the opinion. One ought to remember that doubt about the ability to continue as a going-concern arises when entity faces operational and / or financial difficulties. In certain circumstances it may even lead to a legal obligation on management board to submit an application for bankruptcy. However, discontinuance problems do not always mean that an entity will be a subject of liquidation procedure. Such procedures occur only in extreme situations.

[28] Ustawa z dnia 28.02.2003 roku Prawo upadłościowe, Dz. U. z 2017 r. poz. 2344 ze zm.
[29] Ustawa z dnia 15.09.2000 roku Kodeks spółek handlowych, Dz. U. z 2017 r. poz. 1577 ze zm.

Auditors exposure on two possible mistakes linked to going-concern warnings. If there is such a warning and an audited entity subsequently does not fail it is usually called 'type I error'. Contrary when auditor omits going-concern warning paragraph in the opinion and an entity it is called 'type II error'. It is proven that in most cases type II errors generate much more severe repercussions[30].

Due to risk of discontinuity (in the reasonable future period defined as subsequent 12 months after balance sheet day) auditor's independence is a key factor affecting ability for issuing unbiased qualified or adverse opinion or disclaimer of opinion. There is potential relationship between the fees received by auditors and independence. In my opinion there is a risk that fees affect it at least twofold. Future fees relate to the risk of losing them after audit switch, while present fees define the scope of current audit. There is an observable interaction that high level fee allows auditor to employ appropriate resources (even using external professionals). However, that high level of fee may move towards defending them and consequently may lead to ease auditor's appraisal over audited entity. And finally, may erode auditor's inner strength to report significant difficult issues detected during audit.

There are different concepts set to strengthen auditor's independence. Among others, disclosure of auditor's fees is a tool, which may assess independences by the financial statements' users, because in all earnings received by audit firm are divided on audit and non-audit services. According to the extend theory auditor's independence will be higher when audit fees are disclosed compared to the case in which the fees are not disclosed[31]. Such an obligation has been included in legal requirements of many countries for example in Polish Accounting Act[32].

A going-concern audit opinion often results in significant economic consequences to a company, such as negative stock returns and an increased likelihood of bankruptcy[33]. Of course, there might be other than independence factors that influent on audit opinion. Among many of them it is sometimes arisen that auditors make mistakes due to lack of competences and misunderstanding of audited entity[34]. Second, there may be audit technology implemented by audit firm. Next example cause closely relates to audit technology. It is the range of usage professional judgment of an individual during preparing auditor's opinion[35]. Further, it might be auditing firm size that affects form of opinion, because it is generally accepted that having numerous engagements (and therefore being larger entity) makes auditing firm less dependent on individual client; though declines reluctance of issuing

30 K.-W. Lai, *Audit Opinion and Disclosure of Audit Fees*, Journal of Accounting, Auditing & Finance, Vol. 24, Issue 1, 2009, pp. 91–114.

31 *Ibidem*.

32 Ustawa z dnia 29.09.1994 roku o rachunkowości, Dz. U. z 2018 r. poz. 395 ze zm.

33 A. Kausar, R. Taffler, C. Tan, *The going-concern market anomaly*, Journal of Accounting Research, Vol. 47, No. 1, 2009, pp. 213–239.

34 P. Mutchler, *Auditor's Perceptions of the Going-Concern Opinion Decision*, Auditing: A Journal of Practice & Theory, Vol. 3, Issue 2, 1984, pp. 17–30.

35 J. Mutchler, D. Williams, *The Relationship Between Audit Technology, Client Risk Profiles, and the Going-Concern Opinion Decision*, A Journal of Practice & Theory, Vol. 9, No. 3, 1990, pp. 39–54.

opinion containing going-concern warning. Or finally it may be bargaining power of auditor – the ability to withstand pressure placed on him (or her) placed by audited entity. However, such the pressure of audit switch after issuing qualified or adverse opinion is often softened. If audited entity decides to switch auditor after receiving qualified or adverse opinion, it may be perceived as an entity that is not able to stand up high standards of scrutiny of previous auditor no longer[36]. Although it is not applicable to the companies signing audit contracts for several years, it may still relate to these entities that usually sign one-year contracts.

Notwithstanding, there are non-audit services (provided by auditing firm) that lead to rising objections on the going-concern warnings. The most emphasized problem in literature relates to ability of stating appropriate going-concern risk in opinion because of probable lack of independence and objectivism. These independence and objectivism erode (or at least are perceived as been eroded) when the auditing firm serves services especially related to bookkeeping, internal audit, tax planning, restructuring or business consulting. Audit firms usually would like to obtain subsequent (usually lucrative) non-audit services and some prior research prove that they consider sacrificing independence in exchange for additional future earnings while others have found no influence on perception of their independence [37]. Since majority of the literature conclude that providing non-audit services has a negative influence on auditor's independence and one of the contemporary audit role is developing towards early warning model I formulated two hypotheses:

H1: There is a relationship between continuity problems evidenced by bankruptcies and going-concern warnings (GCW) errors (Type II) in most recent audit opinion.

H2: There is a significant relationship between GCW in audit opinion and non-audit fee existence.

3. Method, results

I investigated empirical data, which are based on sample of financial reports of listed companies as well as auditors' opinions on the reports with special regard of going-concern warnings in appropriate sections in these auditors' opinions. My research for companies which management boards' submitted request for bankruptcy to the court register extended from January 1, 2009 through December 31, 2013. The sample consists of publicly held companies quoted on main market or New Connect market of Warsaw Stock Exchange (Poland) and none of these companies was a financial institution. After identifying initial sample classified by year in which bankruptcy occurred, I narrowed my study to entities registered in Polish registry

[36] P. Barnes, *The auditor's going concern decision and Types I and II errors: The Coase Theorem, transaction costs, bargaining power and attempts to mislead*, Journal of Accounting and Public Policy, Vol. 23, Issue 6, 2004, pp. 415–440.

[37] P. Law, *An empirical comparison of non-Big 4 and Big 4 auditors' perceptions of auditor independence*, Managerial Auditing Journal, Vol. 23, Issue 9, 2008, pp. 917–934.

courts and eliminated foreign companies listed on Warsaw Stock Exchange. Final sample encompasses 59 companies that submitted request for bankruptcy between January 1, 2009 and December 31, 2013 (see table 1).

Table 1. Final sample of companies which management boards' submitted request for bankruptcy to the court register extended from January 1, 2009 through December 31, 2013

No.	Name	Date of request for bankruptcy to the court register	Date of most recent financial statement
1	Gant Development SA	2013-10-11	2012-12-31
2	Internetowy Dom Zdrowia SA	2013-10-09	2012-12-31
3	KCSP SA	2013-10-09	2012-12-31
4	Security System Integration SA	2013-10-01	2013-09-30
5	R&C Union SA	2013-09-26	2012-12-31
6	Europejski Fundusz Hipoteczny SA	2013-08-14	2012-12-31
7	MEW SA	2013-08-13	2012-12-31
8	Richter Med SA	2013-07-31	2012-12-31
9	BGE SA	2013-08-01	2012-12-31
10	Budopol-Wrocław SA	2013-07-29	2012-12-31
11	Mediatel SA	2013-07-16	2012-12-31
12	Fota SA	2013-06-28	2012-12-31
13	Zoo Centrum SA	2013-06-25	2012-12-31
14	Ideon SA	2013-04-03	2012-12-31
15	Motor Trade Company SA	2013-01-31	2012-12-31
16	D&D SA	2013-01-30	2012-12-31
17	Sobet SA	2013-01-09	2012-12-31
18	Euromark Polska SA	2012-11-29	2012-08-31
19	Cool Marketing SA	2012-11-29	2011-12-31
20	Synkret SA	2012-11-28	2011-12-31
21	Waspol SA	2012-11-28	2011-12-31
22	Fabryka Maszyn Ożarów SA	2012-11-23	2011-12-31
23	Call2Action SA	2012-11-15	2011-12-31
24	Partex SA	2012-11-14	2011-12-31
25	Direct eServices SA	2012-10-23	2011-12-31
26	Polskie Jadło SA	2012-09-28	2011-12-31

Table 1 – continued

No.	Name	Date of request for bankruptcy to the court register	Date of most recent financial statement
27	Budus SA	2012-09-28	2011-12-31
28	Alterco SA	2012-09-25	2011-12-31
29	A.PL Internet SA	2012-09-21	2011-12-31
30	Religa Development SA	2012-09-18	2011-12-31
31	Energomontaż-Południe SA	2012-08-10	2011-12-31
32	Wilbo SA	2012-07-19	2011-12-31
33	Bomi SA	2012-07-10	2011-12-31
34	ABM Solid SA	2012-06-29	2011-12-31
35	PBG SA	2012-06-04	2011-12-31
36	Hydrobudowa Polska SA	2012-06-04	2011-12-31
37	Dolnośląskie Surowce Skalne SA	2012-04-06	2011-12-31
38	Intakus SA	2012-04-06	2011-12-31
39	Inwazjapc SA	2012-03-30	2011-12-31
40	Budostal-5 SA	2011-12-30	2010-12-31
41	Advadis SA	2011-10-14	2010-12-31
42	Jago SA	2011-11-02	2010-12-31
43	Drewex SA	2011-10-02	2010-12-31
44	Promet SA	2011-06-27	2010-12-31
45	Huta Szkła Gospodarczego Irena SA	2010-09-17	2009-12-31
46	Internet Group SA	2010-08-19	2009-12-31
47	Polrest SA	2010-07-07	2009-12-31
48	Swarzędz Meble SA	2010-05-19	2009-12-31
49	Orzeł SA	2010-05-27	2009-12-31
50	Grupa Kolastyna SA	2010-03-11	2009-12-31
51	Techmex SA	2009-10-15	2008-12-31
52	Zakłady Naprawcze Taboru Kolejowego w Łapach SA	2009-06-19	2008-12-31
53	Pronox Technology SA	2009-05-27	2008-12-31
54	Alumast SA	2009-05-19	2008-12-31
55	Monnari Trade SA	2009-05-08	2008-12-31
56	Polski Koncern Mięsny Duda SA	2009-03-25	2008-12-31

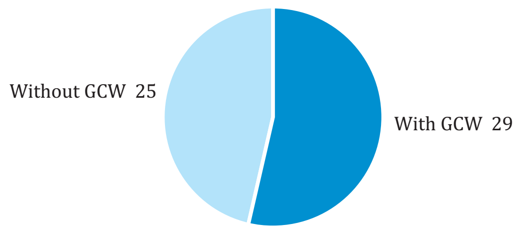
Table 1 – continued

No.	Name	Date of request for bankruptcy to the court register	Date of most recent financial statement
57	Krośnieńskie Huty Szkła Krosno SA	2009-02-01	2008-12-31
58	Sfinks Polska SA	2009-02-17	2008-12-31
59	Odlewnie Polskie SA	2009-01-16	2008-12-31

Source: own work based on Notoria Serwis, EMIS Professional and National Court Register (KRS).

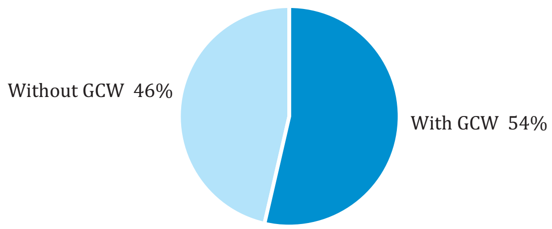
After identifying final sample, I analysed companies' financial statements for the most recent balance sheet day as well as auditors' opinions on these statements. Financial statements and auditors' opinions were downloaded from companies' Internet sites, EBI / ESPI reporting system or EMIS (Emerging Markets Information Services) database. After deleting observations with missing values, the sample consists of 54 auditors' opinions on financial statements of entities requesting for bankruptcy of which 25 did not included going-concern warnings (see graph 1 and graph 2).

Graph 1. Number of auditors' opinions with / without going-concern warnings on companies declared bankruptcy



Source: own work based on Notoria Serwis and EMIS Professional.

Graph 2. Percentage share of auditors' opinions with / without going-concern warnings on companies declared bankruptcy



Source: own work based on Notoria Serwis and EMIS Professional.

To verify justification for committing Type II error by an auditor (forming opinion without going-concern warnings for subsequently bankrupted companies) I assumed that among others there are at least to evident financial signals that may indicate strong financial distress. Irrespective of implemented accounting framework these are:

- negative value of companies' equity capital,
- net loss for the year which absolute value exceeds at least 50% of companies' equity (defined as significant net loss).

Prior research concentrates of different signals that warn about likely future financial difficulties. Among others there may be for example operating loss, negative working capital, negative retained earnings for last three years[38]. Negative value of entity's equity capital seems to be good future financial difficulties indicator because companies with liabilities that exceed total assets may have serious repayment problems since even after monetarization all of the resources some company's debts still remain to be settle. Furthermore, according to Polish Bankruptcy and Reorganisation Law, negative equity capital is a premise for insolvency and require submitting application for bankruptcy (which in fact does not have to lead to liquidation in every single case. Net loss for the year which absolute value exceeds at least 50% of companies' equity (defined as significant net loss), is justified since such a great loss is pretty similar measure to warning signal applied by Polish Commercial Companies Code as a reason for adoption the owners' resolution about further existence of an entity. Lack of detailed information about structure of equity capital (statutory share capital, supplementary capital, revaluation reserves, retained earnings) for sample companies caused the simplification that 50% of companies' equity is more or less cut-off limit for entities' owners that have to make decision about further existence of their companies.

Within 25 companies whose opinions did not contain going-concern warnings there were:

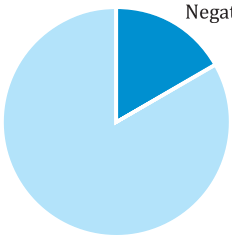
- 3 companies with negative equity in most recent financial statement before requesting for bankruptcy and
- 15 companies reported net loss for the last whole year before requesting for bankruptcy of which:
  - 7 companies reported absolute value of net loss greater than absolute value of equity as at the end of that year.

The structure and numbers of companies with warning signals are presented in graphs 3 and 4.

Within 15 companies with net loss for the year there were also 2 of 3 companies with negative equity. The companies reported negative equity as well as those with significant net loss were audited by non-Big 4 auditing firms (Deloitte, EY, KPMG, PWC).

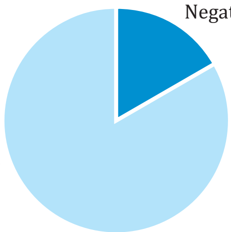
[38] A. Blay, M. Geiger, D. North, *The Auditor's Going-Concern Opinion as a Communication of Risk*, Auditing: A Journal of Practice & Theory, Vol. 30, No. 2, 2011, pp. 79–81.

Graph 3. Companies with strong financial distress that should be warning signals for auditors issuing opinions without going-concern warnings



Note*: there are 2 of 3 companies with negative equity that report significant loss at the same time.
Source: own work based on Notoria Serwis and EMIS Professional.

Graph 4. Percentage share of companies with strong financial distress that should be warning signals for auditors forming opinions without going-concern warnings



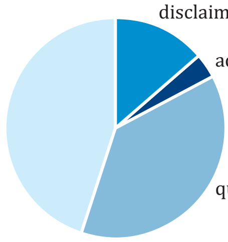
Note*: there are 2 of 3 companies with negative equity that report significant loss at the same time.
Source: own work based on Notoria Serwis and EMIS Professional.

The second pool of opinions (with going-concern paragraphs) is consisted of:

- 4 disclaimers of opinion,
- 1 adverse opinion,
- 11 qualified opinions and
- 13 unqualified opinions with explanation paragraphs (emphasis of matter) only on continuity problems (see graphs 5 and 6).

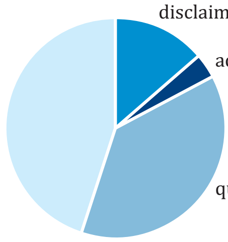
There were only 4 opinions issued by Big 4 auditing firms of which 3 were issued as disclaimer of opinion and 1 unqualified opinion. Regarding to financial signals about company's financial distress it is wondering why such a recognized auditing firm as Big 4 one, released unqualified opinion (however with going-concern warning paragraph) when audited company had negative equity and absolute value of loss for the year reaching 375% of absolute value of equity!

Graph 5. Types of auditors' opinions with going-concern warnings on companies declared bankruptcy



Source: own work based on Notoria Serwis and EMIS Professional.

Graph 6. Percentage share of auditors' opinions with going-concern warnings on companies declared bankruptcy



Source: own work based on Notoria Serwis and EMIS Professional.

Within the group (25 items) without going-concern warnings in most recent auditors' opinions before declaring bankruptcy there were 14 auditing firms that definitely did not provided non-audit services. Only 2 bankrupted companies reported in their financial statement that auditor additionally provided non-audit services and the rest (9 companies) did not disclose such information in their year-end reports which means that financial statement users do not know whether such services were provided and company did not inform about it or maybe services were not provided. In fact, accounting regulations require clear information and it is recommended to disclose appropriate zero-value note rather than omit information entirely. The 2 companies, which were served non-audit services paid for these additional services significant fees. 1st paid over 102% and 2nd paid over 80% of standard audit fee.

4. Conclusions, limitations and future research

The findings may indicate the examined sample proving existence of relationship between continuity problems (defined as requesting for bankruptcy to the registry court) and going-concern warnings errors (Type II) in auditors' opinion. This paper investigated 54 auditor's opinions whose management declared bankruptcy and it occurred that almost 54% of companies received an auditor's opinion without any kind of going-concern warnings. This may lead to conclusions that auditors' expectations on audited business continuity are mostly wrong. Alternatively, their (auditors') procedures implemented within audit engagement are not designed properly or conducted effectively. In effect using auditor's going-concern warnings as a key tool during evaluation of company's creditability is at least disputable. Therefore, empirical evidence may support first hypothesis on relationship between continuity problems evidenced by bankruptcies and GCW errors (Type II) in most recent audit opinion, as far as examined sample is concerned.

The problems with Type II errors relate mostly to effectiveness of auditor's workshop (procedures designed during particular engagement) or auditor's independence. As far as audit procedures are concerned it is highly wondering why 16 of 25 audited and listed companies reporting negative equity or significant net loss for the year (i.e. which absolute value exceeds 50% of absolute value of equity) might have received auditors' opinions without any going-concern paragraph. Having report negative equity capital or relatively huge loss for the year (50% of absolute value of equity), usually indicates material business continuance problems and should attract management concern on further ability for act as a going-concern. It may mean that over 64% opinions should be practically revised due to incorrect audited entity's performance interpretations. Research sample study concludes that most cases relate to non-Big 4 auditing firms.

That is definitely not good news to banks' analysts analysing perspective loan-taker financial standing. Their jobs assume that one of a crucial and helpful tool in assessing clients' opportunity for continuing their businesses is just auditor's opinion. Especially, when such a perspective client is a listed company. Actually, having regard that auditors' opinions are not the only instrument applied during loan procedure, this should lead to significant change in auditors' opinion perception by banks and push them towards implementing new more effective instruments in evaluating clients' situations. That conclusion is addressed especially to smaller banks (including cooperative banks) which credit risk procedures are simpler and depends mainly on auditor opinion and financial statement.

Second potential issue relating to Type II errors relates to relationship between including going-concern warnings and non-audit fees earning by the auditor. The study on research sample may not support that conclusion due to relatively small number of auditing firms delivering non-audit services. Since there were only 2 companies which explicitly disclosed fees for paid non-audit services and 9 with any disclosure on that issue it is not justified to make reasonable outcomes. Especially when empirical data from pool with going-concern warnings show that there were 5 opinions issued by auditors serving the same client non-audit services. Fortunately, according to 537/2014 European Union[39] regulation – legal

[39] Regulation (EU) no 537/2014 of the European Parliament and of the Council of 16 April 2014 *on specific requirements regarding statutory audit of public-interest entities and repealing commission decision* 2005/909/EC, Official Journal of the European Union L 158/77.

framework for EU companies – most of non-audit services (including tax services, bookkeeping, payroll and valuation services) are not permitted any more.

While the findings indicate observable (but not significant) relationships between audit services range and going-concern warnings in auditors' opinions we cannot determine causality. Though, we are not allowed to ascertain existence causal relationship between delivering non-audit services by auditors and quality of going-concern statement in appropriate sections of auditors' opinions. Notwithstanding I found a field in audit legal framework that may require further discussion and maybe (in the future) additional regulation. Therefore, it suggests a need for further investigations in this area.

Some limitations of this paper should be noted. Although serving non-audit services to audit clients is perceived to be important issue in the auditing literature empirical studies, including this one, give no one and only right answer on influence of such services on auditor's independence and audit quality. Another limitation is that my research related to public companies, which requested for bankruptcy. Further and broader research should cover larger sample of companies that received Type II errors in auditors' opinions on their financial statements. An interesting avenue for future research would to examine both publicly listed and private companies' auditor opinions. Next limitation refers to definition of bankruptcy. It is company's management's request submitted to the registry court that was defined as bankruptcy. Notwithstanding it does not exist one and only appropriate definition of company's bankruptcy. There are some studies relate to company's default defined in a completely different way.

Taken together, these studies on examined sample suggest that there may be association between Type II error and company's ability for business continuity, which is not good news. These findings should be useful to users of auditors' opinions, especially to banks, since they treat auditors' assessment of prospective (or existing) debtors' likelihood to act as going-concern as important tool loan-taker evaluation. There are capital market authorities and audit standards setters that should be familiar to the issue while releasing their expectations on auditors' procedures and outcomes included in auditors' opinions (like Polish Audit Authority or Financial Market Authority) and support stronger auditors' opinions users' expectations. And finally, an important implication of the study is that it emphasises the continuing problematic nature of serving audit and non-audit services, even in situations where the non-audit services comprise only traditional taxation services. Of course, there exists new requirement related to quoted companies in EU that prohibit serving non-audit services to public companies, but problem with private (not publicly hold) companies still remains.

Finally, it is worth emphasizing that future survey research can also be conducted on independent auditors and their relationship with audit clients. It is recommended sample size to be extended to all companies – including private (not quoted) entities.

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