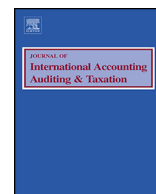


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# Journal of International Accounting, Auditing and Taxation



## Audit report information content and the provision of non-audit services: Evidence from Spanish lending decisions



Andrés Guiral<sup>a,\*</sup>, Emiliano Ruiz<sup>b</sup>, Hyun Jung Choi<sup>a</sup>

<sup>a</sup> Yonsei University, South Korea

<sup>b</sup> University of Cádiz, Spain

### ARTICLE INFO

#### Article history:

Available online 3 February 2014

#### Keywords:

Audit report information content

Auditor independence

Non-audit fees

Going concern opinions

### ABSTRACT

This study examines whether auditor economic independence affects the information content of going concern audit reports in the European setting. We conduct an experiment where 80 experienced Spanish loan officers from the second largest European commercial bank review a loan request under two lending scenarios: (1) a potential borrower receiving an unqualified but modified going concern opinion, and (2) a potential borrower receiving a qualified going concern opinion. Auditor economic independence, measured by the provision of non-audit services (NAS), is manipulated (absence vs. presence of significant NAS). We find that a qualified going concern audit report is interpreted as a primary warning signal (death penalty). However, the provision of NAS acts as a second order mechanism that only activates loan officers' professional skepticism in the case of an unqualified but modified going concern report scenario. Therefore, we find evidence suggesting that the potential negative impact of a perceived lack of auditor independence depends on the nature of the audit report. Our findings have important implications for the European regulator, which is currently considering establishing an auditor independence regulation framework similar to that in the United States of America.

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## 1. Introduction

One significant input to the lending decision is the borrower's financial statements, which allows loan officers to evaluate current cash flows, predict future cash flows, and assess debt service ability. Because financial statements play such a critical role in the loan evaluation process, the credibility of financial statements is a major concern to loan officers. Consequently, loan officers rely on audit reports as a primary financial information source (Guiral-Contreras, Gonzalo-Angulo, & Rodgers, 2007). This information is particularly helpful in the case of a going concern opinion, where an auditor expresses doubts about the ability of the client firm to continue in existence in the next year (Asare, 1990). A going concern opinion should be informative to loan officers to the extent that such an opinion provides additional information about the borrower's future cash flows, or directs loan officers' attention to the impact of this uncertainty on future cash flows (Bamber & Stratton, 1997). Being transparent and disclosing material uncertainty are crucial issues to avoid a going concern audit report (ICAEW Going Concern, 2009).

Behavioral research has explored the effect of going concern audit reports on lending decisions (Asare, 1990 and Strawser, 1991; Bamber & Stratton, 1997). The findings of these previous experimental studies are not conclusive (Bessell, Anandarajan, & Umar, 2003). While several papers find that qualified audit reports do not provide any specific information

\* Corresponding author at: Yonsei University School of Business, 50 Yonsei-ro, Seodaemun-gu, Seoul 120-749, South Korea. Tel.: +82 02 2123 6567/5452. E-mail addresses: [andres.guiral@yonsei.ac.kr](mailto:andres.guiral@yonsei.ac.kr) (A. Guiral), [emiliano.ruiz@uca.es](mailto:emiliano.ruiz@uca.es) (E. Ruiz), [hyunjung.choi@yonsei.ac.kr](mailto:hyunjung.choi@yonsei.ac.kr) (H.J. Choi).

useful for financial statement users beyond that contained in the financial statements themselves, other studies provide empirical support for the hypothesis that loan officers perceive companies receiving qualified audit reports as being more risky.

Our research is timely since the European regulator is currently considering the possibility of establishing an auditor independence regulation framework similar to that of the United States (Global Governance in Audit Research Team, 2011; Humphrey, Kausar, Loft, & Woods, 2011). Auditor independence is viewed as one of the critical determinants of the credibility of the audit report, and is believed to enhance the quality of financial statements (Church & Zhang, 2011). Because an auditor's independence cannot be observed, the appearance of independence is critical for the public's evaluation of audit quality, and the perceived credibility of the audit report.

A series of accounting scandals recently has shattered public confidence in the audit profession, and the provision of non-audit services (NAS) is perceived as potentially compromising auditor independence (Schneider, Church, & Ely, 2006). The majority of behavioral papers provide evidence that loan officers believe that auditor independence is compromised by the provision of NAS (Nelson & Tan, 2005). Consequently, regulators hope that restricting the provision of NAS by auditors will improve the perceived independence of auditors, and hence audit quality, similar to what happened in the United States after the Sarbanes-Oxley Act (SOX) legislation in 2002. Some critics have called for the revision of the SOX independence requirements (DeFond & Francis, 2005).

This paper contributes to the literature by integrating research on loan officer perceptions of auditor independence with investigations on the information content of going concern audit reports in the European setting. Consistent with Bamber and Stratton (1997), we suggest that the inconclusive results of the information content of going concern reports in prior studies could be due to the omission of variables which may potentially interact with the audit report in loan officer decisions (e.g., the information pertaining to the provision of NAS). Specifically, we conduct an experiment with Spanish loan officers to explore whether the potential negative impact of a perceived lack of auditor independence depends on the nature of the audit report. None of the previous behavioral studies have considered the possibility that the provision of NAS may affect audit report information content. Our results suggest that the information content of going concern audit reports, as interpreted by the loan officers, is affected by the provision of NAS. We observe that the impact of the provision of NAS on loan officer decisions varies with the types of audit opinions the borrower receives.

The remainder of the paper is organized as follows. Section 2 provides a summary of the previous literature and develops our research question. Section 3 describes the research method. Section 4 provides the results of our analyses. Section 5 concludes the paper.

## 2. Previous literature and research question

### 2.1. Information content of going concern audit reports

Results of previous experimental studies on the information content of going concern opinions are mixed (Bessell et al., 2003). Table 1 summarizes the most significant behavioral studies on this topic by country and findings. Table 1 suggests that the lack of consistent findings among studies is not mainly due to differences across countries. Several papers find that going concern audit reports do not provide any specific information useful for financial statement users beyond that contained in the financial statements themselves (Bessell et al., 2003; Elias & Johnston, 2001; Houghton, 1983; LaSalle & Anandarajan, 1997; Libby, 1979). For this reason, part of the literature argues that the impact of a going concern audit report on financial statement users' decision-making is solely based on the events contained in the audit report, rather than on the audit report itself.

Conversely, other behavioral papers provide empirical support for the hypothesis that the audit report can act as an independent second opinion that makes the information contained in financial statements more salient to users (Guiral-Contreras et al., 2007). Firth (1979, 1980a), Gul (1987), and Bamber and Stratton (1997) all find evidence supporting the hypothesis that loan officers perceive companies receiving going concern audit reports as being more risky. For instance, Bamber and Stratton (1997) find that, when a loan application included a going concern audit report, bank loan officers give the application a higher risk assessment and a higher interest rate premium.

While the aforementioned studies have made significant contribution to the audit literature, the mixed results suggest that the role played by the audit report in credit decisions deserves further investigation (Bessell et al., 2003). According to Bamber and Stratton (1997), the lack of consistent results may be due to incompleteness of previous experimental designs. Further, while the effect of going concern opinions can be context-specific, not all contexts have been examined. In this regard, we argue that the provision of NAS may be a critical source of information for loan officers when interpreting the information content of going concern audit reports.

### 2.2. Auditor economic independence and the provision of non-audit services

It has been argued that the joint provision of audit services and NAS to the same client may pose an unacceptable threat to auditor independence (Krishnan, Sami, & Zhang, 2005). However, the independence implications of auditors providing NAS to audit clients have long been a source of controversy in the auditing literature. Certain empirical studies suggest that auditor independence is not negatively affected by the provision of NAS by arguing that (i) the provision of NAS enhances

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