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Audit committees, non-audit services, and auditor reporting decisions prior to failure

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A B S T R A C T

This study investigates the associations between audit committee characteristics and the likelihood of auditors' going-concern decisions among UK failed firms. Specifically, we examine whether the threat posed by auditor-provided non-audit services (NAS) to auditors' reporting decisions is mediated by audit committee characteristics. We find that failed firms with higher proportions of independent non-executive directors (NEDs) and financial experts on the audit committee are more likely to receive auditor going-concern modifications prior to failure, but that there is no significant relationship between NAS fees and the likelihood of receiving a going-concern modification. The evidence further suggests that the association between NAS and auditors' reporting decisions is subject to audit committee characteristics. Where the audit committee is more independent and includes a greater proportion of financial experts, auditors providing the client with NAS are less likely to issue a standard unmodified going-concern report prior to failure. Overall, the findings provide support for corporate governance regulators' concerns about the monitoring benefits of audit committee independence and the presence of financial expertise on the audit committee for auditors' reporting decisions.

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1. Introduction

The study investigates associations between audit committee characteristics and the likelihood of auditor decisions to issue a modified going-concern report[1] in the context of UK failed firms. And in relation thereto we analyze whether reporting decisions made by auditors providing non-audit services (NAS) are mediated by those audit committee characteristics, thus investigating the combined effects of auditor-provided NAS and audit committee characteristics on auditor reporting decisions.

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[1] Hereafter, we refer to a modified going-concern report as auditor reporting opinion in relation to the going-concern status of the entity including qualified opinions, adverse opinions, disclaimers for going-concern issues (International Standard on Auditing (ISA), 705) and unqualified opinions with an emphasis of matter paragraph highlighting the existence of material going-concern uncertainty (ISA, 570). This array of modifications groups together reports differentiable in terms of auditor judgment about the pervasiveness of the effect, or possible effect, on the financial statements (see ISA, 705). Nevertheless, all these modifications would typically indicate a negative view in respect of going-concern as compared to the standard going-concern assumption.

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The research investigations carried out here are justified for a number of reasons. The audit committee, on the face of it, is positioned so as to impact on auditor reporting decisions. It is charged to review and monitor the external auditor's independence and objectivity, the effectiveness of the audit process and the value of auditor-provided NAS. And the audit committee has the responsibility to make recommendations on the appointment, reappointment and removal of the external auditors (UK Corporate Governance Code, 2012). From the agency perspective, it has been assumed that the presence of independent directors and financial experts on the audit committee substantively enhances audit committee effectiveness in monitoring and controlling financial reporting and the external audit - as independent directors and financial experts are assumed to be personnel of high calibre with strong incentives to monitor the financial reporting process (e.g., Klein, 2002; Krishnan, 2005).

Theoretical perspectives on the impact of auditor-provided NAS lead to more of an open question as to whether and when auditor-provided NAS is likely to impair or improve auditor reporting decisions. The dominant perspective points to impairment as auditor-provided NAS are seen to potentially threaten and compromise auditor objectivity and independence: often the consulting nature of NAS places the auditors in roles where they work closely with management; the corresponding fees tend to increase the auditors' economic ties with their audit clients (DeFond, Raghunandan, & Subramanyam, 2002).[2] An alternative view, relying on the knowledge spillover effect, points in a different direction: the provision of NAS is seen to give the auditors more in-depth understanding of their clients, which also benefits the audit (Palmrose, 1986; Simunic, 1984). It is thus not so surprising that prior empirical studies have provided mixed results (e.g. Basioudis, Papakonstantinou, & Geiger, 2008; DeFond et al., 2002).

Given that audit committees are charged with assessing the costs and benefits of auditor-provided NAS, and given that independent directors and financial experts have incentives to monitor and are more capable of overseeing the purchase of auditor-provided NAS, a further perspective of interest is that the influence of auditor-provided NAS on auditor reporting is potentially mediated by audit committee characteristics.

Furthermore, prior empirical research in these areas is relatively scarce. Although a growing number of research papers have attempted to investigate the relationships between audit committee characteristics and managerial discretion in financial reporting (e.g., in terms of earnings management and the level of accounting disclosure), little is known regarding the effects of those characteristics on auditor reporting decisions. We therefore extend the existing corporate governance literature to address this issue in the context prior to failure. Some studies have examined the influence of the audit committee on auditor-provided NAS (e.g. Abbott, Parker, Peters, & Raghunandan, 2003; Zaman, Hudaib, & Haniffa, 2011) but little is known about whether the inter-relationship affects auditor reporting decisions. Again, we extend the literature in this respect.

We can also note here, providing further motivation for our study, the existence of continuing public policy debates in areas related to the focuses of this study. There is the continuing concern of regulators, reported often in prior literature, about the majority of failed companies failing in the absence of a timely auditor opinion indicating going-concern uncertainty (see House of Lords, 2011; The Sharman Inquiry, 2012).[3]A series of corporate failings over the last two decades has intensified regulatory concerns about auditor-provided NAS and audit committees' responsibility in respect of monitoring this area. An auditor's going-concern modification in this respect is considered useful information to feed into company appraisal including in terms of appreciation of the increased likelihood or risk of impending corporate failure. The absence of a timely going-concern modification prior to corporate failure is often cited as evidence of audit failure and is often linked both to weak corporate governance and to auditor-provided NAS. Since auditors are charged with the responsibility to assess an entity's going-concern risk and to identify events or conditions that may cast significant doubt on an entity's ability to continue as a going concern (International Standard on Auditing (ISA), 570), the decision not to modify the going-concern assumption in the audit report issued immediately prior to failure raises eyebrows and motivates further reflection as part of an attempt to explore and assess auditing and corporate governance – including the role of the audit committee - in practice (The Sharman Inquiry, 2012).[4] To address the concerns, corporate governance reformers have considered the audit committee as having a central role (e.g., Smith Report, 2003; UK Corporate Governance Code, 2012).

[2] Such matters and considerations may at least create dilemmas for external auditors. The going-concern opinion can be a *direct* outcome of an auditor's ostensibly professional decision, but translating this into a report may be understood to involve a negotiation of the auditor, management and audit committee. Many see the potential for tension here, particularly the possibility that corporate management may pressurize the auditor not to issue an unfavorable opinion, which could, e.g., impact on the share price (see Blay & Geiger, 2013; Citron et al. 2008; Menon & Williams, 2010). Such tension potentially puts at stake auditor income streams: while replacing auditors can attract to the company the negative attention of the market, there is documented evidence that auditors are more likely to be replaced after issuing a going-concern modification – indeed potentially the outcome can be the losses of benefits accruing to the auditor generated by all their work for the client, leaving aside other reputational effects (see Carcello & Neal, 2003). Further, for Sharma and Sidhu (2001), a firm facing impending failure has an enhanced need for NAS, giving the auditors further incentives to delay a going-concern modification.

[3] For example, Citron and Taffler (1992) and this study report that only 26.2% and 34%, respectively, of UK failing firms had received an auditor's modified report for going-concern uncertainties. Research has found that around one half of US bankrupt firms had received such a report (Feldmann & Read, 2010; Mutchler et al., 1997).

[4] It should be noted that none should hold it reasonable to expect auditors to foresee all instances of failure. Likewise, a decision not to modify the going-concern assumption cannot be taken to guarantee company survival. There are dangers of resting upon or coming too close to such positions even among policy-makers and academics. More reasonable here, however, consistent with the substance of prior literature, is the position that auditors can potentially make decisions along a spectrum of reasonable, independent and expert decisions (or unreasonable and poor decisions) based on practices of varying degrees of reasonableness and expertise that influence the audit report's usefulness vis-à-vis appreciations of corporate failure likelihood (see DeFond et al., 2002). Prior literature suggests the manifestation of corporate failure the more appropriate context for analysis of the determinants of and appraisal of the auditor's going-concern report because within a year prior to failure the typical failing company shows relatively unambiguous financial distress symptoms that are more likely to have reached the threshold of going-concern uncertainty to merit modification (Hambrick & D'Aveni, 1988; Citron & Taffler, 1992; see Sharma & Sidhu, 2001; Callaghan et al., 2009).

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