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Determinants of going concern opinions and audit fees for development stage enterprises

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ABSTRACT

Startup entities have been the focus of much political and academic interest recently. Development stage enterprises (DSEs), as defined by SFAS 7, are startup entities for which some publicly available information exists. New accounting standards have removed the DSE designation and related extra reporting requirements, and placed more responsibility on owners and managers to assess the ability of entities to continue as a going concern. We examined information from financial statements and audit reports of companies previously reporting as DSEs to investigate what increases the likelihood of receiving a going concern modification in auditors' opinions (GCO) and what affects audit fees. Our overall analyses indicate that the asset size of DSEs, negative working capital, and prior-year going concern modifications consistently influence going concern modifications to auditors' opinions. Managers should clearly consider these conditions when making their assessment of their companies' future going concern status. Our results indicate that the size of the audit firm did not influence the going concern modification decision, but Big4 auditors charge significantly higher fees than other auditors. Thus, managers/owners of DSEs should weigh the benefits of having a Big4 firm audit on their financial statements against the higher fees charged by those firms.

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1. Introduction

Policymakers have recognized that smaller companies (enterprises), including startup entities, are important for innovation and future economic growth. These companies are also more likely to be faced with going-concern conditions than established entities. In 1975, the FASB (1975) issued SFAS 7, *Accounting and Reporting by Development Stage Enterprises* that defined a category of companies as DSEs and regulated their financial reporting. Under SFAS 7, companies meeting the FASB definition of a DSE, to comply with GAAP, had to disclose more information (e.g., inception-to-date data) than other companies. According to SFAS 7, DSEs were companies that conducted substantially all their efforts to establishing a new business and had not begun planned principal operations, or had begun operations, but had not generated significant revenue. Consequently, companies reported as DSEs should serve as a valid proxy for startup entities that are important for innovation and future economic growth.

To raise capital through equity or debt, many DSEs need to have their financial statements audited by independent accountants. When financial and other conditions indicate the existence of *substantial doubt* that a company will continue as a going-concern, the auditors issue an

auditor's report containing a going-concern emphasis-of-matter (explanatory) paragraph that describes those conditions. Research has shown that receiving an auditor's report with a going-concern modification may impede an entity's ability to raise additional capital. Even though potentially large amounts of money may have been invested in DSEs, due to their nature, financial statements of most DSEs receive auditors' opinions with a going-concern modification.¹ However, many DSEs receive unqualified (clean) auditors' opinions without a going-concern modification.

The Public Company Accounting Oversight Board (PCAOB, 2014) is now reviewing going-concern related standards due to investor dissatisfaction with current reporting practices. Also, the Financial Accounting Standards Board (FASB, 2014a, 2014b) issued new updates related to Development Stage Enterprises (DSEs) and going-concern opinions. Likewise, the IAASB (2015) has issued ISA570 (revised) on Going Concern.² Unlike prior research, this study focuses on determinants of going-concern opinions (GCO) in auditor's reports and audit fees for DSEs, a set of relatively small publicly traded startup companies. Distinct from typical samples, over 59% (862 out of 1448) of these companies received a GCO, and the majority of DSEs were audited by other (not Big4

¹ The breakdown of our sample in Table 1, Panel B illustrates the extent to which DSEs receive going concern opinion modifications.

² The International Auditing & Assurance Standards Board (IAASB): ISA 570 (revised) — Effective for audits of financial statements for periods ending on or after December 15, 2016 (<http://www.ifac.org/system/files/publications/files/ISA-570-%28Revised%29.pdf>).

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or Tier-2³) auditors. Also, these relatively small, other auditors issued the highest proportion (662 out of 862, i.e., 77%) of GCOs included in the sample.

This study investigates what factors influence why some DSEs receive going-concern opinions (GCO) and others receive no-GCO (clean) opinions. Also, because audit costs can be substantial for a startup company, we examine determinants of audit fees charged to DSEs. Results indicate that going-concern modifications for DSEs are significantly more likely/frequent for relatively smaller companies (measured by the log of total assets), companies with negative working capital, and companies that received an auditor's going-concern modification in the prior-year. Despite other (non-Big4 or Tier-2) audit firms issuing the largest proportion of GCOs to DSEs, we found little evidence that the going-concern modification decision is impacted by audit firm size. We also found no evidence that going-concern modifications significantly affect the log of audit fees for DSEs. However, sensitivity analysis provided some evidence that going concern opinions might affect audit fees as a percent of assets (Audit fees ÷ Total assets) for larger DSEs. As expected, Big4 audit firms charge higher fees than other auditors of DSEs.

The next section describes our motivation for this study and our research questions. We then review prior literature, followed by discussions of our research methods and results. Limitations to our study and areas for future research are discussed before we provide a summary and conclusion.

2. Motivation and research questions

Research confirms the importance of financial information/statements to investors in early-stage business ventures. Armstrong, Davila, and Foster (2006) found that investors considered many reported expenses and sales relevant to assess the value of companies prior to Initial Public Offerings. The nature of reported expenses was important because investors viewed some of early-stage companies' costs incurred as investments made for a foundation having the potential to increase future revenue. Gavius and Schwartz (2008) concluded that investors used continuously increasing or decreasing reported sales by a DSE to measure its market penetration and viability. Smolarski, Wilner, and Yang (2011) found that as startup companies matured, private equity funds increasingly used audited financial statements as valuation tools indicating the importance of audited financial statements. Likewise, Foster, Garrett, and Shastri (in press) found that a clean (unqualified) auditor's report provides potential investors with a more effective/persuasive signal than an independent accountant's review or compilation report. Therefore, the clean audit report increased the likelihood of new/startup enterprises obtaining funding and reduced the amount of additional information entrepreneurs must provide to obtain financing from investors/lenders compared to statements that are reviewed or compiled.

Because financial information is important to investors in start-up organizations, the perceived reliability of that information should also impact potential investors' decisions. Potential investors' perceptions may be impacted by whether the independent accountant's report accompanying the financial information is unqualified or contains a going-concern modification. Also, auditor quality, as evidenced by audit firm size, could impact potential investors' perceived reliability of the financial statements (DeFond & Lennox, 2011).

Management is responsible for preparing financial statements in accordance with generally accepted accounting principles (GAAP).

GAAP assumes that an entity will continue to be a going-concern unless circumstances indicate otherwise. Doubt about the ability to continue as a going-concern is present when an entity faces serious operating and/or financing difficulties; in extreme situations, such an entity may have to liquidate. Under the FASB definition of DSEs, one would expect DSEs to more likely face going-concern difficulties than established businesses due to operating, financing and other factors.

To conform to GAAP, the financial statements of companies facing difficulties must make proper disclosures relating to going-concern issues and management's plans/actions to mitigate such problems; the auditor's opinion contains a going-concern emphasis-of-matter paragraph (GCO) following the opinion paragraph. In contrast, auditors would issue a *clean (unqualified)* audit report (non-GCO) without an emphasis-of-matter paragraph to a DSE not facing going-concern problems. This emphasis-of-matter paragraph draws users' attention to the DSE's going-concern conditions and could lead them to request/obtain appropriate additional information with which to make informed investment decisions (see Carson et al., 2013). In contrast, financial statements of DSEs with an unqualified (no-GC) opinion may be perceived by users as similar to those of established entities.

Investors likely prefer DSEs to engage Big4 audit firms because of their credibility. In addition to their perceived credibility, Big4 firms are perceived to have deep-pockets and have the resources to service large clients. Consequently, large public companies are mostly audited by a Big4 audit firm. For example, in 2006, the four largest auditing firms audited 98% of the 1500 largest public companies with annual revenues over \$1 billion (U.S. Department of the Treasury, 2008, II:1). However, because Big4 firms are likely to charge more for their audit services, not all companies can engage Big4 firms. In fact, some small enterprises, presenting a relatively high level of engagement risk (particularly DSEs faced with going-concern conditions) would be less likely to be accepted as audit clients by Big4 firms.

2.1. Going-concern standards

The term *substantial doubt* has not been adequately defined and its application in the audit process has not been well established, leaving the decision to auditor judgment. More reliance on judgment could increase the likelihood that auditors act to minimize their exposure to litigation or yield to management pressure, rather than protect investors' interests. Consequently, auditor's GCO-related reporting decisions may frequently be erroneous, adversely affecting the entity, investors, and/or the auditor. For example, an auditor may issue a report with a GCO when in fact the entity under audit does not experience any financial/operating difficulties (type I error), or the auditor may issue a clean/unqualified (no GCO) audit report when in fact the entity under audit goes into bankruptcy (type II error). Francis (2004) observed that although bankruptcies of public companies per year were few, seven of ten bankrupt companies received a clean audit report for the year prior to bankruptcy (Type II error). Also, six out of seven going-concern opinions were issued for companies that did not subsequently fail or become financially distressed (Type I error). These numbers suggest that auditing standards could be improved to reduce audit reporting errors, which would benefit business entities and investors.

In fact, the PCAOB's Investor Advisory Group reported (PCAOB_IAG_01, 2012) that success with standards covering consideration of GCOs in audits has been somewhat spotty. A PCAOB report identified deficiencies in existing standards and provided several recommendations for improvement based on a survey of investors (PCAOB_IAG_02, 2012). The PCAOB (2014) is now reviewing going-concern related standards. As mentioned earlier, the IAASB issued ISA 570 (revised) on going concern matters, which becomes effective for audits of financial statements for periods ending on or after December 15, 2016.

The FASB has also expressed dissatisfaction with going-concern standards. A FASB news Release from 2014 notes that GAAP provides

³ Big4 audit firms are Deloitte & Touche, Ernst & Young, KPMG, & PricewaterhouseCoopers. Another indication of audit firm size is that the PCAOB annually inspects audit firms that audit more than 100 public companies. For 2015, in addition to the Big4 firms, the PCAOB conducted annual inspections of BDO USA, Crowe Horwath, Grant Thornton, MaloneBailey, Markham, and McGladrey & Pullen (<http://pcaobus.org/Inspections/Pages/default.aspx>). Hence, we refer to these firms as Tier-2 audit firms (significant in size but smaller than Big4).

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