The ethics of going concern audit opinions through the lens of universalism

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ABSTRACT

In rendering an audit opinion on an entity's financial statements, generally accepted auditing standards require auditors to modify the audit opinion, with an explanatory paragraph, when there is a presence of "substantial doubt" as to the entity's ability to continue as a going concern in the foreseeable future. Prior research indicates that year after year numerous public companies held clean, unmodified audit opinions just prior to filing bankruptcy. While many studies have analyzed going concern opinions in the context of auditor characteristics, firm size, pre and post Sarbanes-Oxley time periods, and much more, this study looks at going concern audit opinions from an ethical perspective. With the recent events of COVID-19 and the ensuing impact on the economy, the presence of going concern issues will naturally become more and more prevalent. Using universalism as a theoretical basis, this study approaches the decision-making process of going concern audit opinions as an ethical dilemma and develops a decision model to assist auditors in making these decisions, and to further allow the auditor to view the going concern decision as an ethical duty.

Keywords: Accounting ethics, audit opinions, auditor ethics, going concern, universalism

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INTRODUCTION

Prior research indicates that year after year numerous public companies held clean, unmodified audit opinions just prior to filing bankruptcy (e.g., Altman, 1982; Altman & McGough, 1974; Menon & Schwartz, 1986; Chen & Church, 1992; Mctague, 2011; Ryu et al., 2009). In rendering an audit opinion on an entity's financial statements, generally accepted auditing standards (GAAS) require auditors to modify the opinion, with an explanatory paragraph, when there is a presence of "substantial doubt" as to the entity's ability to continue as a going concern in the foreseeable future. Although charged with this requirement, auditors are given only suggestions and no enforceable rules and regulations as to what constitutes substantial doubt and furthermore are given no specific procedures or processes to evaluate the company for substantial doubt; auditors are to use their professional judgment. Adding complication, stakeholders sit on opposing ends of the going concern issue. While investors are interested in a company's ability to continue in business, and lenders are interested in a company's ability to meet loan requirements, management is interested in presenting the company in a favorable manner. Given the requirements of the auditor to address going concern issues, the lack of direction as to what constitutes substantial doubt, and the opposing views of investors/creditors and management, much research has been conducted addressing many aspects of this topic. With the recent events of COVID-19 and the ensuing impact on the economy, the presences of going concern issues will naturally become more and more prevalent. To add to these conversations, this study explores the ethics involved in modifying an audit opinion for a going concern issue using the theoretical underpinnings of universalism. The study specifically addresses the following question: Is it ethical for an auditor to issue an unmodified (clean) audit opinion for a public company when a going concern issue exists?

GAAS's Statement on Auditing Standards (SAS) 59 and AU 341, both titled "The Auditor's Consideration of An Entity's Ability to Continue as a Going Concern", require auditors to express an opinion on the fairness of financial statements in accordance with generally accepted accounting principles (GAAP) (AICPA, 1988a). Auditors select from four opinion types when rendering an audit opinion; unqualified opinion, qualified opinion, adverse opinion, and disclaimer of an opinion (AICPA, 1988a). In addition, SAS 59 and AU 341 require an auditor to modify the opinion, with an explanatory paragraph, when a going concern issue is present (AICPA, 1988b). An underlying assumption in the conceptual framework of accounting, specifically in the area of financial reporting, is an entity's ability to continue as a going concern. Financial statements are prepared with the idea that, absent any information to the contrary, an entity will operate indefinitely. When this assumption is challenged or absent, due to entity circumstances, there are both valuation and stakeholder implications, thus indicating the importance of knowing whether an entity can continue as a going concern (Spiceland, 2020). Valuation implications exist due to requirements to revalue certain assets and liabilities when there is a going concern issue, reflecting a current liquidation value of the assets and liabilities (Spiceland, 2020). As previously noted, stakeholder implications exist for both internal and external parties, as investors and lenders are interested in a company's ability to continue in business and pay their debts, and management is interested in a favorable presentation of the company's financial condition.

SAS 59 and AU 341 charge the auditor with "…the responsibility to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements"

(AICPA, 1988b, p. 2). SAS 59 and AU 341 provide suggestions, but no specific rules and regulations, as to what constitutes substantial doubt (AICPA, 1988b; FASB 1989). Some conditions that may give rise to substantial doubt include negative trends such as recurring operating losses and financial difficulties such as loan defaults and debt restructuring. If substantial doubt is present, it is the auditor's responsibility to obtain from management any plans to address these circumstances, evaluating these plans as to whether or not they provide mitigating factors to offset the substantial doubt and whether or not these plans are likely to be effectively implemented (AICPA, 1988b). SAS 59 and AU 341 also provide suggestions, still no set rules or regulations, on what constitutes effective management plans (AICPA, 1988b; FASB, 1989). Some plans that management may consider are disposing of assets and borrowing money. If, after evaluating management's plans, substantial doubt still remains, the auditor "…should (1) consider the adequacy of disclosure about the entity's possible inability to continue as a going concern for a reasonable period of time, and (2) include an explanatory paragraph (following the opinion paragraph) in his audit report to reflect his conclusion" (AICPA, 1988b, p. 3). This explanatory paragraph is what causes the opinion to be classified as a going concern opinion (GCO).

Adding to the ambiguity of SAS 59 and AU 341 is the explicit statement that auditors are not predictors of future events. The lack of direction given in SAS 59 and AU 341, coupled with the opposing views of stakeholders presents an ethical dilemma for the auditor. Therefore, it is important to explore the ethical aspects of the GCO, asking the question: Is it ethical to issue an unmodified (clean) audit opinion for a public company when a going concern issue exists?

LITERATURE REVIEW

Investors, lenders, and other financial statement users rely on audit opinions for decision making purposes. Despite this reliance, prior research concluded that less than 50% of companies filing for bankruptcy received audit opinions that had been modified for going concern issues (e.g., Altman, 1982; Altman & McGough, 1974; Menon & Schwartz, 1986; Chen & Church, 1992; Ryu et al., 2009). Literature indicates the usefulness of the GCO. Schaub and Highfield (2003) conducted research to measure investor reaction and found resulting negative returns following the issuance of a GCO, concluding that the modified opinion influenced investor behavior and provided the investors with useful information. Blay et al. (2011) examined financially distressed companies finding a market shift in the companies that received a going concern modification with no comparable market shift for similarly matched companies not receiving a going concern modification, concluding that the GCO contains information that the public finds useful. While these research examples indicate that GCOs contain useful information, other research is unable to support this finding. Mutchler (1985) conducted research and was unable to resolve the question of whether the GCO offered the public anything in addition to what can be gleaned from the information available to the public through financial statements and annual reports already available to them. Mutchler (1985) concluded that, for most companies, the GCO did not appear to have additional information content.

Management also has a stake in the audit opinion, as the opinion reflects their company and its financial condition. Many management teams believe that a GCO is a self-fulfilling prophecy; the opinion itself causing the demise of the company. Therefore, management may argue or persuade the auditor against issuing the going concern modification even in the presence of substantial doubt, arguing the concept of a self-fulfilling prophecy. Literature shows that self-

fulfilling prophecy may alter the auditor's professional judgment regarding the GCO. Guiral et al. (2011) conducted research to determine if an auditor's belief in the self-fulfilling prophecy influenced whether the auditor issued a GCO. The research found that auditors having a belief in the self-fulfilling prophecy are less responsive to contrary evidence (contrary to continuance) and more responsive to mitigating factors (mitigating the doubt), both cases resulting in an unmodified (clean) audit opinion (Guiral et al., 2011).

Auditors, and the audit firms they represent, also have a stake in the opinion, as the issuance or non-issuance of a going concern modification could have implications on their integrity, reputation, and client relationships. There may also be legal implications for the auditor. Mong and Roebuck (2004) researched auditor litigation risk, studying whether an audit opinion modified for a going concern issue reduced potential auditor litigation risk. They found that an opinion modified due to a going concern issue can significantly reduce auditor litigation risk. Literature explores two types of errors regarding the issuance of a GCO; Type I audit opinion errors and Type II audit opinion errors (e.g. Fargher & Jiang, 2008; Koh, 1992; Mutchler et al., 1997; Wertheim & Fowler, 2005). Type I audit opinion errors occur with the issuance of a GCO when a clean audit opinion is warranted, as evidenced by the subsequent continuity of the entity. Type II audit opinion errors occur with the issuance of a clean audit opinion when a GCO is warranted, as evidenced by the subsequent failure or bankruptcy of the entity. Literature reflects concern regarding both types of errors. Koh (1992) examined the costs associated with Type I and Type II errors noting the intangible and hard-to-measure costs of loss of reputation, loss of existing and potential clients, threat of lawsuits, loss of dividends, and misguided investments. These costs accrue to the various stakeholders involved in the going concern dilemma. Koh (1992) and others (e.g. Feldman & Read, 2010; Fargher & Jiang, 2008) note the negative relationship of Type II and Type I errors. The propensity to issue GCOs in an effort to decrease Type II errors, will increase the potential for Type I errors, and vice versa. Thus, giving rise to an ethical dilemma for the auditor.

Accounting and finance literature address various stakeholders involved in issuing a GCO, the influence these stakeholders may have on an auditor's opinion, and the costs associated with Type I and Type II audit opinion errors. The literature indicates the importance of the going concern issue and the ethical dilemma involved in deciding whether the opinion should be modified to address a going concern issue. Unfortunately, the ambiguity of SAS 59 and AU 341 may provide the auditor with justification for either action.

ETHICAL THEORIES AND THE RESEARCH MODEL

Responsibilities of the Auditor

The AICPA Professional Code of Conduct (The Code) contains principles and rules to be followed by their members. While not all accountants belong to the AICPA, there is a general consensus that those practicing the profession of accounting (even those outside the membership of the AICPA) have a public duty to adhere to the principles and rules found in The Code (Duska et al., 2011). These rules stem from six principles. These principles are (1) responsibility to act in a professional manner, exercising professional and moral judgment, (2) serve the public interest and honor the trust of the public (3) perform duties with a sense of integrity (4) display objectivity, being free of any conflict of interests and act in a manner that is both independent in fact and independent in appearance, (5) exhibit due care by performing duties with competence

and diligence, and (6) recognize the scope and nature of services to be provided, as presented in The Code (AICPA, 2013).

Resolving Ethical Dilemmas in Auditing

In addition to The Code, ethical theories can provide a basis on which to analyze and solve ethical dilemmas including the ethical dilemma an auditor may face in deciding whether to issue a GCO when a going concern issue exists. Two common theories used in accounting literature to provide ways in which to resolve ethical dilemmas are utilitarianism and universal duties (Duska et al., 2011). When considering the business motive of an accounting firm (client retention and longevity of the firm), a third theory, egoism (acting in one's own self-interest), may appear to deserve consideration as a viable ethical theory. However, as noted by Duska et al. (2011), in reference to the use of egoism theory, "Clearly, it [egoism theory] is not acceptable in the accounting profession, where the code of ethics mandates the accountant's obligation to act in a way that will serve the public interest" (p.53). For this reason, the theory of egoism is not used in this study to resolve the ethical question being considered.

While Jeremy Bentham first wrote about utilitarianism, John Stuart Mill was an influential contributor to the theory (Wood, 2007). The theory of utilitarianism is based on doing what brings about the greatest good for the greatest number of people. In the context of this theory, Mill (1863) defined "good" in terms of the consequences provided by the action. Therefore, utilitarianism is concerned with evaluating the consequences for all stakeholders involved and selecting the action that promotes the greatest good for the greatest number of people (Mill, 1863). While utilitarianism may appear to be an appropriate ethical theory to use in resolving ethical dilemmas, in the context of auditing and issuing audit opinions, the auditor is not merely charged with the responsibility of promoting the greater good for the greater number of people, but instead is charged with a duty to financial statement users. Utilitarianism's focus on consequences ignores or minimizes the idea of moral obligation and moral duty of the auditor. This duty is reflected in The Code's principle to serve the public interest and honor the trust of the public, and was echoed by Justice Warren Burger's comments regarding the responsibilities of auditors:

> The auditor does not have the same relationship to his client that a private attorney does…who has a role as…. a confidential advisor and advocate, a loyal representative whose duty it is to present the client's case in the most favorable possible light. An independent CPA performs a different role…the independent auditor assumes a public responsibility transcending any employment relationship with the client…performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public (as cited in Duska et al., 2011, p. 116).

This "ultimate allegiance" to creditors, stockholders, and investors is the auditor's duty to these stakeholders. For this reason, the theory of universal duties (universalism) and deontology is used to resolve the ethical question being considered.

The theory of universal duties, a part of deontology, was developed in the 1700's by Immanuel Kant. Unlike the utilitarians, Kant was not concerned with consequences (the end) but more so with the means to the end; the action itself, and the intent of the action. Therefore, theory of universal duties is concerned with whether the act and the intent of the act are right, correct, or justifiable. Based on this theory, Kant developed categorical imperatives in order to demonstrate ethics and principles to live by. He believed that these imperatives "…are governed

by reason and take the form of absolute principles derived at and justified through logic" (Wood, 2007, p. 194). These absolute principles dictate and provide guidance to our actions. Kant demonstrates these principles in three formulations; universality and reversibility, respect, and moral community. Universality and reversibility states that one should "…only act if the principle of your action applied universally is not self-defeating" (Wood, 2007, p.194). The universality portion of this formulation considers an act to be ethical if the person responsible for the action is "…willing to have his or her intent made into a universal law; everyone in the same situation should then be free or even encouraged to act in exactly the same way" (Hosmer, 2011, p. 96). The reversibility portion of this formulation extends the idea of universality. If the principle is universal, then the person considering the action must be prepared to also be on the receiving end of the action. Reversibility is concerned with whether the person considering the action is "…prepared to accept the consequences of other people using it in ways that harm you or that thwart your desires or intentions" (Wood, 2007, p. 195). Kant's second formulation, respect, is concerned with the treatment of others, and states that we should "…always treat others as ends unto themselves, and never solely as means to an end" (Wood, 2007, p.195). Kant did not mean that people should not be used as a means to an end, but that they should not be treated only as a means, and not treated in any other way (Wood, 2007). He noted that all persons should be treated as being "…worthy of dignity and respect, and never as means to his or her own ends" (Hosmer, 2011, p. 96). In applying this formulation, all stakeholders and the treatment of these stakeholders, should be examined to ensure that no stakeholder is being treated with disrespect. The third formulation, moral-community, states that "…we should act as if you were a member of a moral community governed by moral principles that can be universally applied without becoming self-defeating, and that treat every person with respect" (Wood, 2007, p. 196). Kant acknowledged that we live in a world full of unethical acts and unethical intentions. As a result, we may be led to believe that we cannot do anything about the world in which we live. However, when we "act as if we lived in a world governed by universality, reciprocity, and respect, then we act in faith" (Wood, 2007, p. 196). In applying this third formulation, a person is to ignore the "everyone else is doing it" justification in their actions and intentions. We are to "act as if" everyone is acting ethically and therefore, there should be no belief that our actions won't matter or that our actions won't make an impact in an unethical world.

THE MODEL AND RESULTS OF THE MODEL

As noted by Duska et al. (2011), "Because of their joint responsibility to various groups – clients, colleagues, and the public – it is inevitable that accountants will sometimes face conflicting pressures". The model developed and shown in Figure 1 (Appendix) can be used to assist the auditor in resolving these conflicting pressures. Here, it will be used specifically to answer the auditor's ethical dilemma found in the following question: Is it ethical to issue an unmodified (clean) audit opinion to a public company when a going concern issue exists?

Stakeholders and the Facts

The first step in the model is to name the stakeholders and state the facts of the action being considered. The facts stated here are not to be considered specific facts that the decision model is dependent on (resulting in an "it depends" answer to the model), but instead are for the

purpose of demonstrating step 1 in the model. In other words, these are hypothetical facts representing facts that are generally present in circumstances when management appeals to the auditors to forego the issuance of a GCO. The stakeholders are the auditors, management of the company, and the financial statement users including shareholders, creditors, banks, etc. The facts of the ethical dilemma being considered are as follows: The audit committee of a public company has hired an external audit firm to audit the financial statements of the company. There are circumstances present within the company that are contrary to the assumption that the company will continue as a going concern within the foreseeable future (defined by SAS 59 and AU 341 as one year). Management believes that the company will navigate through these "difficult times" and will continue as a going concern, and therefore, makes an appeal to the auditors to forego the issuance of a GCO. Management fears, and expresses this fear to the auditor, that the issuance of the going concern will have a negative effect on the market value of their stock and will impede management's progress in addressing the difficulties they are currently experiencing. Management believes that they will be successful in overcoming the difficulties, however, feel strongly that the issuance of a GCO will, in itself, cause the demise of the company; the demise of a company that, in management's opinion, would otherwise survive indefinitely. The auditor decides to forego the issuance of the GCO, and instead issues a clean, unmodified audit opinion.

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Intent of the Action Expressed in a Rule or Principle

The next step in the model is to take the facts of the action being considered (the issuance of an unmodified [clean] opinion) and state the intent of these actions as a rule or principle. Based on the facts, the intent of the action would be expressed as a rule or principle as follows: In order to preserve the market value of a company's stock, and avoid the risk of failure for a company that may otherwise prove to be successful, auditors will not inform financial statement users of circumstances that appear contrary to the company's ability to continue as a going concern.

Answering the Questions from the Model

The next step considers the information gathered from the previous steps and answers the questions presented in the model. Although answering the first question may bring about an answer that indicates the action is unethical, continuing through the model, answering all questions will provide the decision-maker with a complete analysis of the action, resulting in a more informed decision. Following are answers to the questions presented in the model:

Universality

If everyone acted on the principle, is the principle self defeating? In other words, what would happen if everyone acted in this same manner, with the same intent, under similar circumstances? What would happen if every auditor acted with the intent of protecting the company? The intent of the action is to protect management and the company, at the risk of being untruthful to (or at the very least withholding the truth from) the financial statement users and the public in general. As mentioned earlier, the duty of an auditor is to the public first and to the employing company second. If all auditors acted with the intent of protecting the company's

interest over the interest of the public, then the trust that the public must have in auditors in order for auditing to maintain its purpose and integrity, would be diminished. Eventually, auditors would not be trusted by the public and audit opinions would become meaningless and no longer useful. Therefore, it can be concluded that auditors would not want this principle to be a universal principle.

Reversibility

If everyone acted on the principle, would you be willing to accept the consequences of other people using it in ways that harm you? If everyone acts on this principle and withholds the truth from financial statement users, and further if these businesses subsequently fail, the auditor may suffer loss. This loss can be in the form of loss of reputation or monetary loss due to litigation involving creditors that loaned money to the company and/or investors that invested in the company. The auditor can possibly end up being worse off. Therefore, it can be concluded that the auditor would not want this principle to be used in a way that would bring harm to them.

Respect

Given the action being considered, will any of the stakeholders be disrespected (treated "merely" as a means)? Yes, the financial statement users will be disrespected, as they are having the truth withheld from them; a truth that they have a right to and that they view as the auditor's duty to tell them. Therefore, it can be concluded that the action will cause financial statement users to be disrespected.

Moral-Community

Is the "act as if" principle being applied in the action being considered? In the action being considered (the issuance of a clean opinion when a going concern issue exists), the "act as if" principle is not being applied. Prior research revealed that less than 50% of failed companies received a GCO, meaning that the issuance of a clean opinion, when a GCO is warranted, occurs far too often (e.g., Altman, 1982; Altman & McGough, 1974; Menon & Schwartz, 1986; Chen & Church, 1992; Ryu et al., 2009). Because previous questions in the model have determined that this action is self defeating and disrespectful (to the financial statement users), in order to "act as if" we live in a world where everyone is acting ethically and that our ethical actions will matter, the auditor should refrain from the action. Therefore, not refraining from the action is not applying the "act as if" principle but is instead going along with what others are currently doing.

Decision

Based on the results of the model, the act of issuing an unmodified (clean) audit opinion for a public company when a going concern issue exists is not ethical. It is deemed unethical when applying the theory of universal duties because it would not be desirable for the intent of this action to be a universal principle, an auditor would not want the act, if made a universal principle, used against them to bring harm to them, the act causes the financial statement user to be disrespected, and the "act as if" principle is not being applied in the course of the action.

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CONCLUSION AND FUTURE RESEARCH

Accuracy rates regarding GCOs still indicate high levels of audit inaccuracies. Prior research concluded that less than 50% of companies filing for bankruptcy received audit opinions that had been modified for going concern issues (e.g., Altman, 1982; Altman & McGough, 1974; Menon & Schwartz, 1986; Chen & Church, 1992; Ryu et al., 2009). Given that the audit opinion is the primary means in which the auditor communicates to financial statement users, the issuance and non-issuance of GCOs are important topics that matter to auditing and to the business world in general. Therefore, the examination of the ethics involved in a GCO decision provides first, the recognition of the issue as an ethical issue, and second, insight as to why auditors fail to issue the proper warning signal when a company is experiencing difficulties that may result in the company's failure. It is the concern of some that the ambiguity of SAS 59 and AU 341 lead to the issuance of an unmodified (clean) opinion when a GCO is warranted (Hahn, 2011). The ethical dilemma seems to be inherent in SAS 59 and AU 341 themselves. While it charges the auditor with the responsibility (duty) of reporting going concern matters to the investor, it also seems to provide protection to the auditor in the non-issuance of a going concern issue. This protection is provided in a few ways. First, the standard merely suggests what may give rise to substantial doubt and what may provide mitigating factors. Second, the standard specifically states that the auditors are not predictors of the future. Why make a statement that auditors are not predictors of the future, and within the same standard, charge them to be just "that" (predictors of the future)? And further, charge them with this responsibility with no clear-cut rules and regulations as to when it is appropriate to issue a GCO. This indicates the topic's future implications regarding future standards or at least the re-visiting of current standards. Developing an understanding of the ethics involved in issuing a GCO can help sort out these varying viewpoints and can assist regulators in making decisions, writing future standards, and adjusting current standards and their current requirements. Future studies should include further analysis of accounting ethics through the lens of other ethical theories that may find merit in the accounting discipline. Future studies should also include a pre and post COVID-19 look at ethics, as the importance of considering the decisions regarding GCOs will likely become more pronounced in the current climate with the unknown fallout of COVID-19; how it will impact the economy as whole, and the GCO decisions specifically.

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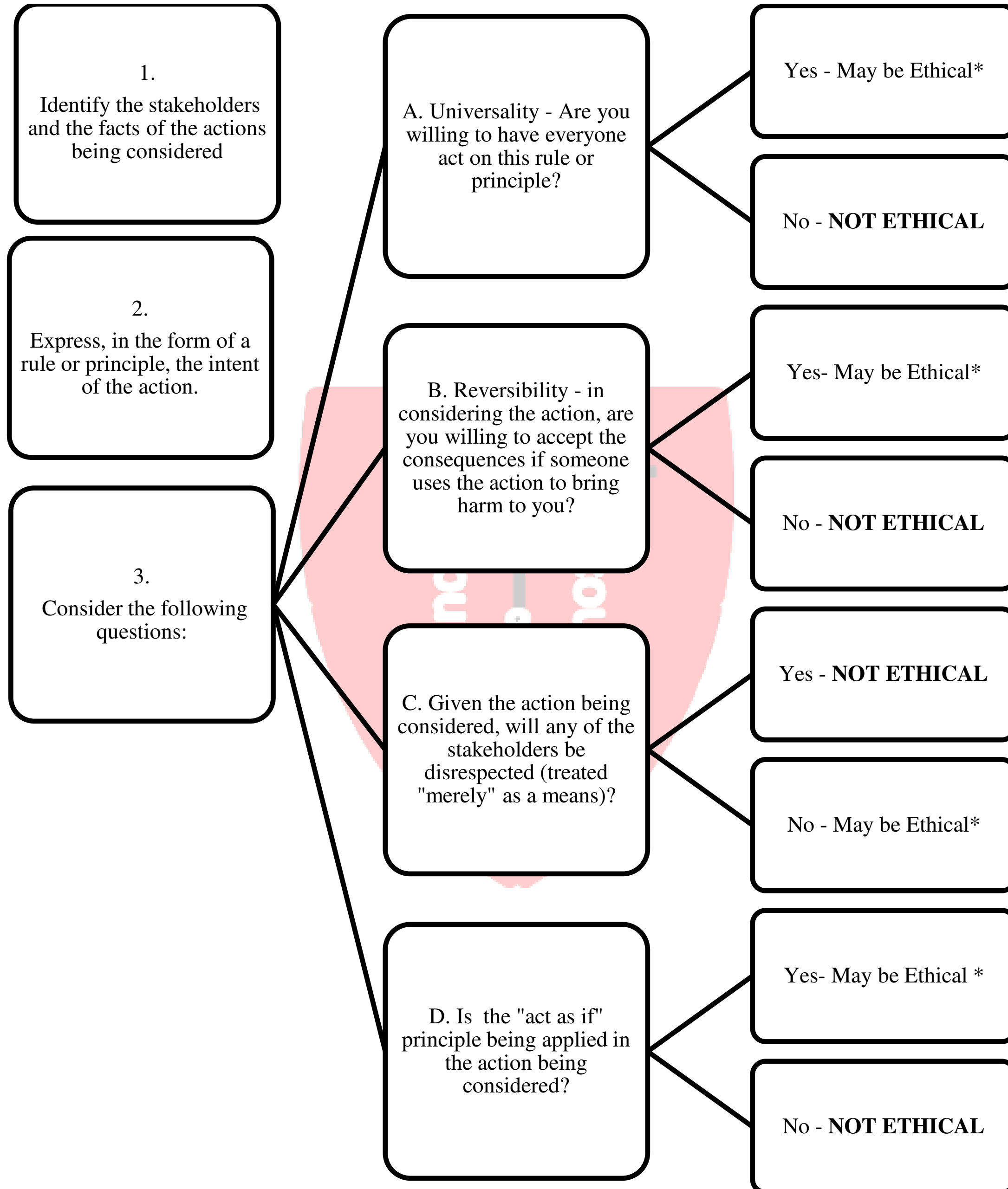
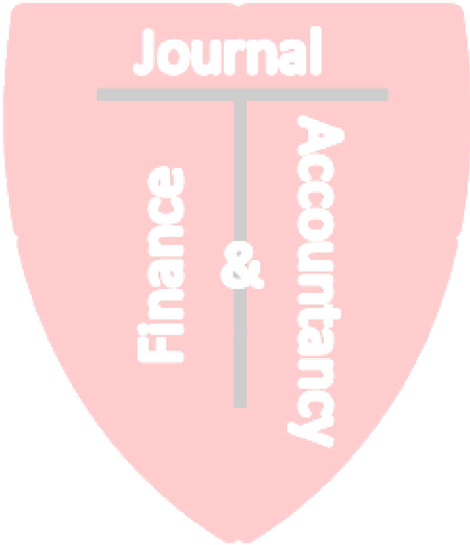
APPENDIX

Figure 1 – Model Using Universal Duties to Resolve Ethical Dilemmas in Auditing



Note: If the action being considered progresses through ALL questions without resulting in a "NOT ETHICAL" answer, then the action is ethical in accordance with the theory of universal duties. If any of the questions result in a "NOT ETHICAL" answer, the action is not ethical in accordance with the theory of universal duties.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