Going-Concern Assumption and Disclaimer Opinion: The Italian Case

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***Abstract* — The going-concern (GC) assumption is a fundamental principle in the preparation of financial statements in many countries. For this reason an evaluation on the capability of the entity to continue in business for the foreseeable future is a central element in the audit process. After introducing the influence that GC assumption plays on the audit opinion, this paper aims to verify what has happened to the Italian listed companies after receiving a disclaimer opinion for inappropriate evidence regarding the use of the GC assumption.**

Index Terms* — *Going-concern, auditing, disclaimer opinion, bankruptcy

I. Introduction

The going-concern assumption (GC), also known as the «continuity assumption», is relevant for two different types of subjects: directors and auditors.

It is relevant for directors, because in each country the GC is a fundamental precondition in order to draw up financial statements. Indeed, financial disclosure can be prepared according to "going-concern" or to alternative basis of accounting (e.g. "liquidation"). Whereas it is relevant for the auditor because the work is focused on the expression of an opinion on the presence of condition for the adoption of GC assumption.

The GC opinion is worthy of attention because it serves as an example of auditing standard because it is fairly consistent worldwide, although the practice may be vary [1].

Martin [1] compared the accounting and auditing standards of France, Germany and the US, showing how GC assumption was essentially the same. However in the US firms the disclosure rates on GC were significantly higher. These results are in total agreement with La Porta [2] who shows that Common-law countries have stronger investor protection laws and more developed financial markets than Civil-law countries. Even though many studies suggest that there are cross-national variations regarding the implication of going-concern reporting [1]-[3].

The first definition of GC accounting found in the auditing literature, the US *AU Section 341* states that the auditor is responsible for evaluating the existence of any «substantial doubts» about the ability of the firm to continue its business for a reasonable period of time. It means that the company will be able to continue in operation for the foreseeable future realizing assets and discharging liabilities in the normal course of the operations. But the US *SAS 59* also points out that the auditor is not responsible for predicting future conditions or events.

Most researches about GC modifications deem a firm to be failing only if it has filed for bankruptcy. Bankruptcy is a discrete and measurable event, this is the reason why it is often used in measuring auditor going-concern behavior [4]. Furthermore bankruptcies not preceded by GC audit reports are widely viewed as audit failures [5].

When auditors issue a GC modification and the firm continues in business, this does not indicate that the firm is financially healthy. A dated empirical study [6] indicates that one third of the firms receiving auditor GC opinion modifications filed in bankruptcy. A third of the firms went out of business or were acquired by, or merged with another firm. Finally for one third the opinion was clean. This study emphasizes that two thirds of these firms fail. Furthermore, it was also found that auditor GC decisions were inferior to the predictions of failure prediction models [7]. This comparison is based on the large proportion of auditor errors made. For a review of the literature, see Klee [8].

From the perspective of the company, a GC modified opinion generally produces additional financial hardships if it leads to a further loss of customers, and reduced access to credit and loan funds [9], thus leading to reluctance on the part of suppliers, customers and resource providers to do business with the company [10]-[11]. For instance, the standard response of bankers to a GC modification is to freeze existing lines of credit. The sum of these elements is highly related to a decline in share price [12]-[13].

These factors might yield an increase in the probability of company failure [14]-[15]. In fact, many studies produce evidence that company failure rates might be higher following the issuance of a GC modification (e.g. [16]-[17]).

In the last decades events like the bankruptcy of big companies such as Enron (with the demise of Arthur Andersen), WorldCom, Parmalat and many others have altered the perception of the GC assumption. Many studies emphasise the evolution of GC evaluation by auditors. Geiger and Raghunandan [18] found that auditors were less likely to qualify firms in financial distress in the period before 1993 than the period after 2000. Some years later, Geiger and Raghunandan and Rama [17] found that before Enron only 40% of the companies entering bankruptcy had obtained a GC modification, whereas after Enron the rate grew to 70%. In 2006 Nogler [4], using the same bankruptcy metric but

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expanding the sample, confirmed a rate of 44% ante-Enron and 63% post-Enron. Nogler and Jang [4] tested different measures from the pre and post Enron period. Their study shows that in post Enron period the auditor's assessment became more strict. The percentage of companies where auditors noted a GC modification with a negative net income decreased as well as the percentage of companies with a working capital deficiency.

Regarding the quality of the evaluation on GC, Geiger and Rama [20] point out that the Big Four audit firms made fewer GC decision errors than the other firms. Therefore there is a great deal of evidence in the US that the Big Four auditors perform higher quality audits than other auditors [21]-[22]-[23].

II. Going-concern opinion in ISA 570

The Italian financial reporting framework (art. 2423-bis of the Civil Code) states that financial statements must be prepared on a GC basis. This means that assets and liabilities are recorded so that the entity will be able to realize its assets and discharge its liabilities in the normal course of business in a foreseeable future.

A GC evaluation is essential when management does not intend or is not obliged to liquidate the entity or to cease business. On the contrary, when the use of the GC assumption is inappropriate, assets and liabilities must be recorded with a different basis of accounting.

If the management's judgment on the entity's ability to continue as a GC points out that there is an uncertainty, they must specify it. Moreover, if the financial statements are not prepared on a GC basis, the management must emphasize it and explain the reasons for this choice. Management must also clarify the criteria used to draw up the financial statement.

The Management's assessment on the ability to continue business in a foreseeable future has to consider all the available information in order to guarantee that the business will remain functional during at least one year following the date of the financial statements. Obviously one year is the minimum period.

The level of detail of this analysis depends on specific circumstances such as:

- the firm has a history of profitable operations and easy access to financial resources: in this case the evaluation on the capability to carry on business may be made without performing detailed evaluation procedures;
- in other cases: this type of evaluation must consider the process which management followed to make its assessments, with particular attention to the management's plans and their reliability.

ISA 570 requests that in the entire auditing activity, from the planning to the opinion, the auditor has to consider the GC assumption as a key element when drawing up the financial statement.

As well as the management's assessment, auditors have to verify the company's performance to evaluate whether it's appropriate to use a GC approach or not. The extent of this assessment depends on the financial situation of the company. It is possible that during the auditing process auditors recognize signals that may not confirm the presence of GC assumption. In this case auditors must adopt specific audit procedures in order not only to prove correct application of the Italian GAAP, but also to improve the knowledge of the firm's performance and financial stability. The role of analyst is assigned to the auditors, thus obliged them to assess the ability of the firms to carry on its business in a foreseeable future. This evaluation is fundamental in order to choose the correct basis to be used to prepare financial statements. If the evidence from this analysis suggests a lack of GC and the financial statement is prepared on a GC basis, it will not be compliant with the national regulations.

A. The impact of assessment of GC assumption on the auditor's opinion

The process aimed establishing the presence or not of the GC assumption is divided into three steps:

- the carrying out audit procedures;
- the acquisition of sufficient information;
- the verification of the effects produced by the management's business plan.

At the end of these steps, auditors have to evaluate whether the uncertainties on GC have been solved in a satisfactorily way.

After this evaluation the auditor may come cross:

1. a use of GC assumption appropriate;
2. a use of GC assumption inappropriate;
3. a management unwilling to make or extend its assessments.

1) use of GC assumption appropriate

If the GC assumption is considered to be appropriate with reasonable assurance, the auditor will issue an unqualified opinion (also known as «clean opinion»).

If the CG assumption can be considered appropriate when it is supported by corrective elements (business plans, etc.), the auditor will consider the information disclosed in the financial statement.

The possible scenarios are:

- adequacy of disclosure of material uncertainty that suggests the possibility that the entity will be able to continue the normal course of business: in this case an unqualified opinion will be issued but the report will present also an emphasis of matter about the presence material uncertainty;
- inadequacy of disclosure of material uncertainty although GC assumption is proved: in this case a qualified opinion for inadequate disclosure will be expressed or an adverse opinion if the disclosure inadequacy is so substantial as to make the financial statement not able to present a fair financial position.

In situations involving multiple material uncertainties that are significant for the financial statement as a whole, the auditor may consider it appropriate in «extremely rare» cases to express a disclaimer of opinion instead of adding an Emphasis of matter paragraph.

2) use of GC assumption inappropriate

If the auditor's analysis does not support the possibility that the firm will be able to carry on its business in a foreseeable future there are two different situations:

a) the financial statements have been prepared on a GC basis: in this case the auditor must express an adverse opinion because the financial statement is inappropriate;
b) the financial statements are prepared on an alternative basis (for instance on liquidation basis): in this case the auditor can express an unqualified opinion but it may be considered appropriate to include an Emphasis of matter paragraph to put focus attention to the alternative basis and the reasons for its use.

A particular situation can occur when the date of the financial statement precedes the shareholder passing resolution.

The different options are presented in the following figure.

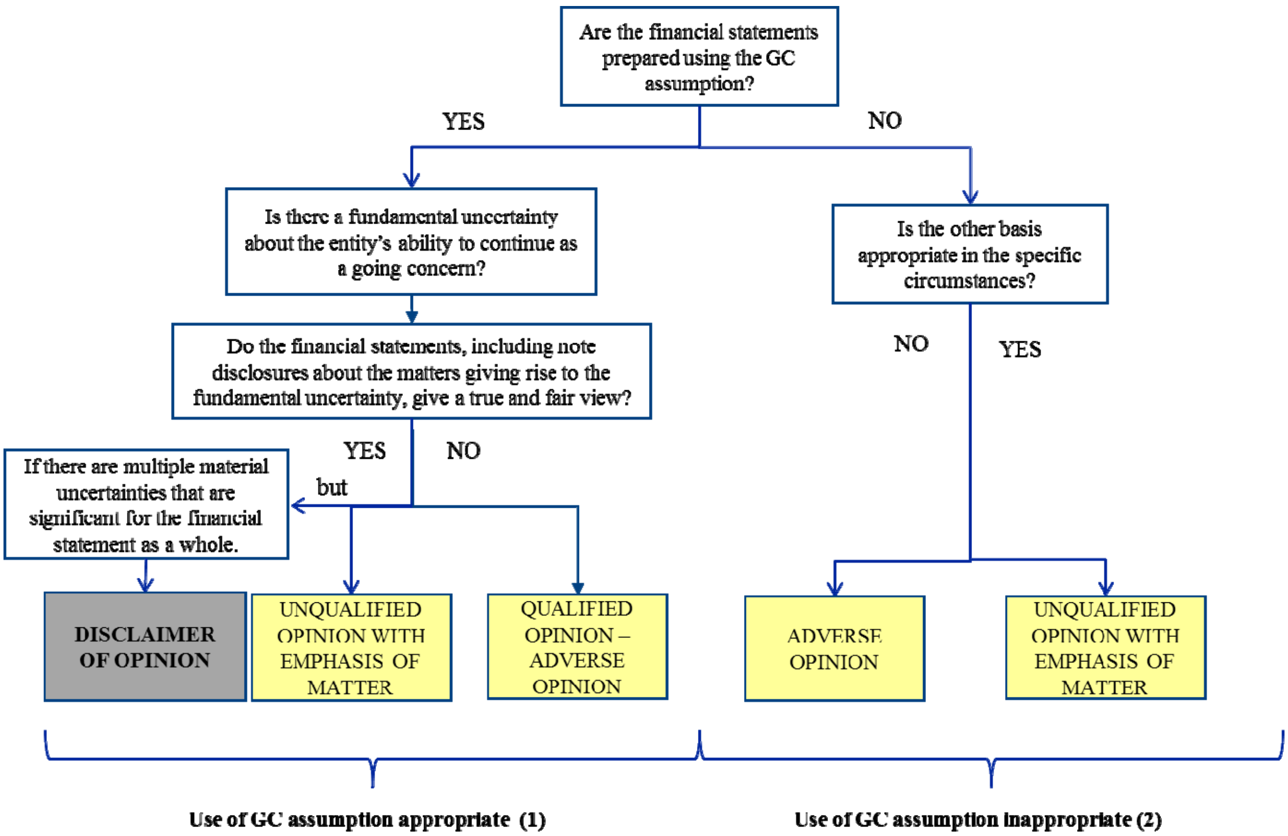

Figure 1 – Influence of GC assumption on the audit opinion.

3) *management unwilling to make or extend its assessment*

In some cases the auditor considers it necessary to request the management to make or extend its assessment. However if management does not accept it, the auditor must evaluate the effects that these limitations produce on the activity.

In certain circumstances, without that extension in the analysis or because of a lack of information (perhaps because there isn't business plan or forecasts), the auditor may not be able to obtain sufficient appropriate audit evidence (and is not responsible for that non-fulfillment) and so a disclaimer opinion is appropriate. In other circumstances an insufficient analysis does not preclude the possibility for the auditor to evaluate the presence of GC assumption. For instance, if in the past the firm had obtained good performances and it had not had problems finding financial resources it is possible for the auditor to evaluate GC position.

III. Data and Question Research

After having introduced cases in which GC assumption influences the audit opinion, this paper aims to verify what happens to the Italian listed companies (Milan Stock

Exchange) after they have obtained a disclaimer opinion for inappropriate evidence regarding the use of the GC assumption.

The sample is based on 1,395 audit opinions expressed on all Italian companies' financial statements from 2004 to 2008.

Of these 1,395 opinions, 30 are disclaimer opinions for uncertainty on the GC presence. These 30 opinions are ascribed to 21 different companies. Our observation includes the five-year period (from 2004 to 2008) but it has been further extended to verify the consequences also to the three-year period following (from 2009 to 2011).

The main question of this research is:

(Q1): How many companies filed for bankruptcy after receiving a disclaimer opinion in the five-year period examined?

IV. Empirical results

The evidence of our empirical analysis is shown in Table 1 below:

TABLE I
COMPANIES FILED FOR BANKRUPTCY

	Company	2004	2005	2006	2007	2008	2009	2010	2011
1	Algol	D	D						
2	Centenari e Zinelli (now Investimenti e Sviluppo)	A					D	D	D
3	Eurofly (now Meridiana Fly)			D					U (E)
4	Eutelia (NTS)					D			
5	Fin.Part	D							
6	Fullsix				D				U
7	Giovanni Crespi (*)					D	D		D
8	I Viaggi del Ventaglio		D	A		D	D		
9	Innotech - Cornell bhn - Yorkville Bhn - Sintesi	D						D	U
10	Ipi			D	D				U
11	Montefibre,					D	D	D	D
12	NGP	D				D	D	D	D
13	Omnia Network SpA					A	A		
14	Pagnossin	D	D	A					
15	Richard Ginori 1725 (*)	D	D	A					D
16	Sadi Servizi Industriali					D			U
17	Snia					D			
18	Socotherm					D	D		
19	Tas Tecnologia Avanzata dei Sistemi Spa			D					U (E)
20	Tiscali					D			U (E)
21	Trevisan Cometal					D			
	Audit opinions expressed	***263***	***272***	***283***	***294***	***283***	***Tot.***	***1395***	
	Number of opinion modification on GC	***7***	***4***	***6***	***2***	***11***	***Tot.***	***30***	
	%	***2.7%***	***1.5%***	***2.1%***	***0.7%***	***3.9%***			

Key: A (adverse opinion), D (disclaimer opinion), U (unqualified opinion), U (E) (unqualified opinion but with emphasis on matter paragraph).

(*) Failed after 2011.

In the five-year period observed, our research shows that the number of companies that obtained a disclaimer on GC opinion range from 2 in 2007 (0.7% of the total) to 11 in 2008 (3.9% of the total).

Table 2 summarizing the results shows that:

- 11 out of 21 companies (52%) have failed. That number also includes companies that are filed for bankruptcy and companies that are delisted due to financial instabilities to date;

- 3 out of 21 companies (14%) received in 2011 a disclaimer opinion for inappropriate evidence regarding the use of the GC assumption (the number is calculated without considering companies that failed after 2011). Two of them have obtained in the last years four consecutive disclaimer opinions and the other one "only" three. These trends suggest a high probability that they will fail. ;
- 3 out of 21 companies (14%) have obtained an unqualified opinion on GC but the auditor has considered it appropriate to include an Emphasis of matter paragraph;
- 4 out of 21 companies (19%) have solved their GC problems receiving a qualified opinion on GC uncertainty.

TABLE II
RESULTS

Period 2004-2011	**Company**	**%**
Disclaimer opinions from 2004 to 2008	21	100%
▪ default *	11	52%
▪ disclaimer opinion in 2011	3	14%
▪ unmodified opinion with an emphasis of matter paragraph	3	14%
▪ problems solved	4	19%
Total	21	100%

V. Conclusion

The evidences from this empirical analysis shows that, after a disclaimer opinion due to GC, only 1 company out of 5 has been able to solve its financial instability completely. More than half of them have failed because they have filed for bankruptcy or have been delisted due to the crisis. A further 14% continued their business receiving disclaimer opinions. This suggests that the number of companies' default will probably increase in the near future. This risk is supported by observations regarding the financial instability of the three companies that in 2011 obtained an disclaimer opinion once more. In particular two of them have subscribed to a debt restructuring, and the other one has made a special agreement with creditors to avoid collapse. The sum of the companies which have failed (52%) and the companies that in 2011 registered problems (14%) prove our results are completely in line with Nogler's percentages [6] as presented before.

Moreover, an analysis of the companies which, according with the auditors, have solved their GC problems, shows that two of them registered negative incomes in separated and consolidate financial statements in 2012. Furthermore, their consolidated net assets are negative.

These results suggest that the financial statement's users must consider the disclaimer opinion due to GC as a highly dangerous warning. The high risk recognized justifies the restriction to the credit line by capital providers. However, as has been illustrated in other studies, this financial hardship may bring forward the bankruptcy of the firm.

An interesting point for future research could be the evaluation of the companies that have filed for bankruptcy and that had previously been judged by auditors as able to continue their activity.

In addition the three-year period, as it is known, has been characterized by a worldwide financial crisis that has surely produced implications on GC assumption. A comparative analysis between the pre and post current crisis may shed light on the alteration that the crisis has produced on the auditors' strictness in the evaluation on GC assumption.

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