NO13045

Experience and Risk-Taking Tendencies in a Going Concern Judgment Task

Brian M. Nagle (Contact Author)
Associate Professor
John F. Donahue Graduate School of Business and
A. J. Palumbo School of Business Administration
Duquesne University

and

C. Gustav Lundberg
Professor
John F. Donahue Graduate School of Business and
A. J. Palumbo School of Business Administration
Duquesne University
&
Docent, Swedish School of Economics and Business Administration
Helsinki, Finland

Track: Accounting

Description

While a rich body of research on going concern decisions exists, an important question that remains relatively unanswered is why, given a common body of audit evidence, do some auditors decide to modify the standard audit report while other auditors do not? The lack of consensus in going concern judgments may be rooted in the latitude inherent in such decisions. Given a body of evidence germane to the continuity assessment, differences may exist across auditors in the perceived relevance of specific audit evidence and the interpretation and weighting of that evidence when estimating the likelihood that the client will not continue as a going concern.

One factor that may contribute to differences across auditors regarding evidence collection, its evaluation and the audit report deemed most appropriate for the situation, is experience. Importantly, experience has the potential to influence the extent to which risk aversion an individual exhibits in a given task. An existing body of decision theory literature suggests that individuals more familiar with a risky decision task tend to be less risk averse than individuals with greater familiarity with the decision task (Bateson, 1966; Ladouceur, Tourigny, and Mayrand, 1986). This reduced risk aversion is likely to manifest itself in a variety of ways ranging from bolder decisions to a greater reliance on non-mainstream decision inputs when reaching the decision.

The purpose of this study is to examine whether novice, but experienced, auditors exhibit less risk aversion than auditing students (about to enter the profession) in a going concern decision task. We expect this reduced risk aversion to manifest itself in several ways. First, we posit that students will be more likely to make "safer" audit report decisions by issuing a going concern modification to a financially-troubled hypothetical client. In addition, we expect that students will focus greater attention on negative audit evidence and be more influenced by this evidence when arriving at an audit report decision. Along these same lines, we expect experienced participants to exhibit a greater tolerance for the presence of negative audit evidence as evidenced by higher derived going concern thresholds. As a result, we examine the following hypotheses in this study:

H_1: *Students are more likely than the novice auditors to issue a going concern modification in the going concern decision task.*

H_2: *Students will identify a greater proportion of negative signals (suggesting the client will not continue as a viable entity in the foreseeable future) than the novice auditors.*

H_3: *Derived going concern thresholds will be lower for students than novice professionals indicating less of a tolerance for negative audit evidence when making a going concern report decision.*

The psychology literature suggests that decision makers may engage in some form of self-protection from regret when making an unconventional choice in a risky decision. This might be manifested by decision makers "silently" convincing themselves that there decision is the correct choice despite the fact that conventional wisdom might suggest otherwise. This self-protection process is likely to result in these individuals bolstering their belief that their decision was indeed the correct choice of action and is likely to be evidenced by elevated levels of confidence subsequent to the decision. Consequently, we examine the following two hypotheses:

H_4: *Participants selecting the riskier decision choice (going concern modification) will be more confident in their decision than those selecting an unmodified report.*

H_5: *Students will be more confident in their decisions than novice professionals.*

Sample

Our participant pool consisted of 90 novice professional auditors employed by large, regional and small audit firms in the Pittsburgh, Pennsylvania area and in Columbus and Cincinnati, Ohio. In addition, 141 advanced undergraduate auditing students representing three Pittsburgh area universities also participated in this study. Our data collection was performed subsequent to the coverage of going concern assessments and decisions in the respective auditing class.

Procedure

Participants were presented with a seven-page (2,643-word) instrument containing financial (including financial statements) and non-financial information about a hypothetical audit client. The instrument included signals that are typically encountered when making a going concern judgment. The information was based on a publicly traded company, which we renamed ABC Corporation on the instrument. We did, however, maintain references to the company’s particular business sector. This procedure maintained the realism of the task, while minimizing the risk of a participant being directly familiar with the history of the particular firm. The company was identified and the data obtained from the *Compact Disclosure* database. Seeking a complex and ambiguous case, we chose a company that received an unmodified audit report, but filed for bankruptcy protection within the next year. The instrument pages can be summarized as follows: Page 1: *Consolidated Balance Sheets*; Page 2: *Consolidated Statements of Operations*; Page 3a: *Consolidated Statements of Cash Flows* & 3b: *Selected Financial Ratios*; Page 4: *Other Corporate Events* & *Management Discussion Highlights*; Pages 5 & 6: *Selected Notes to Consolidated Financial Statements*; and Page 7: *ABC Corp. Management Forecasts*.

Each participant spent approximately one and a half hours completing the instrument. At least one (but often both) of the authors administered the experiment at the participants' workplace or classroom. Participants were compensated for their time with a modest monetary payment.

Participants were asked to isolate signals (pieces of evidence) about ABC Company they believed to be critical to the unmodified audit report/going concern modification judgment. This task involved identifying prominent positive (supporting the company's continued existence) and negative (suggesting potential viability problems for the company) signals. Participants were asked to mark/circle on the instrument any positive signals in blue, and any negative signals in red. At the conclusion of the signal identification task, participants were asked to provide an audit report decision—either unmodified or going concern modification—in light of the evidence that was presented on the instrument.

After providing the audit report decision, participants were asked to rate how much support nine central aspects would render either an unmodified audit report or a going concern modification. These nine aspects –*Cash Flow, Liquidity, Capital Structure, Profitability, Revenue, Financial Flexibility, Industry Trends, Operational Structure, and Litigation*– resulted from an earlier study in which partners and managers were asked to identify the overwhelmingly most important aspects with respect to this particular going concern case. The ratings were provided on a continuous scale ranging from strong support for a going concern modification (with a minimal rating of 0 mm) to strong support for an unmodified audit report (with a maximal rating measuring 125 mm). A score of 62.5 indicates that a participant was neutral with respect to the aspect. In addition to the aspect-rating task, participants were asked to indicate their level of confidence in their decision ranging from 0 mm (minimal rating) to 125 mm (maximum rating.

Current Status

We have completed data collection and are in the process of analyzing the data and writing up our results.

Conclusion

Going concern judgments are among the most consequential that auditors will encounter. These judgments have the potential to invite (1) public scrutiny when, in hindsight, the client's outcome is less fortuitous than indicated by the audit report; and, (2) client friction when, in hindsight, the client proved to be a viable entity after receiving a going concern modification. We expect that our findings will add to the body of decision theory literature by documenting experience-related differences in the tolerance for, the interpretation of and the attendance to negative audit evidence when making a going concern decision. Importantly, our findings should also have implications for educating auditors. A better understanding of how practical experience affects the processing of information in a risky and sophisticated decision task should prove useful in improving the instruction of going concern evaluations in college and university auditing classes.