AUDITOR’S REPORTS IN AUSTRALIA 2005-2015: AN UPDATED ANALYSIS

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1. INTRODUCTION

The aim of this report is to update our previous report (Carson, Zhang and Fargher 2014 which examines the period 2005 to 2013) and examine the frequency of the various types of auditor’s reports issued in Australia during the period 2014 to 2015, with a focus on reports emphasising material uncertainty in regard to the going concern assumption.

Prior research has shown that auditor’s reports with a modification or an Emphasis of Matter (EoM) for uncertainty relating to the going concern assumption increased following the shock of the Global Financial Crisis (GFC) in late 2007. This occurred in Australia from 2008 where Xu et al. (2011) found that reports with going concern related modifications and EoMs increased from 12% in 2005 to 2007 to 18% in 2008 and 22% in 2009. Similar trends are observable for the United States as shown by an increase from 14% in 2003 to 21% in 2008 (Audit Analytics, 2015, Geiger et al. 2014). As economies have recovered from the GFC, it might be expected that lower rates of uncertainty regarding a company’s ability to continue as a going concern would be observed. This has been the case in the United States, where after a peak in 2008, going concern related modification and EoM rates have steadily declined through to 2014 which is observed to have the lowest level of going concern related modification and EoM rates in the fifteen year period 2000-2014 (Audit Analytics, 2015). Whether similar trends are observed in Australia is an open question.

Our initial analysis indicates a substantial increase in unmodified auditor’s reports with EoM paragraphs rising from 13% in 2005 to 22% by 2009 following the GFC, and a continuation of this trend to 25% in 2012 and 32% in 2013 which is then maintained at 32% in 2014 and 34% in 2015. The increase is strongest for smaller companies and particularly for companies in the materials and energy sector. Qualifications of auditor’s reports in general remain around the 3-5% level.

Figure 1. Distribution of Auditor’s Reports by Type of Audit Opinion 2005-2015

This paper is organised as follows. Section 2 summarises the sample examined in this study. Section 3 provides a brief summary of the types of auditor’s reports in Australia. Section 4 provides a summary of the trends in auditor’s reports. Section 5 provides a greater focus on trends in the reports modified for going concern uncertainty. Section 6 analyses the outcomes of auditor’s opinions over the study period. Section 7 concludes the report.
2. SAMPLE

We reviewed 19,360 auditor’s reports for Australian publicly listed companies, representing around 98% of the companies listed on the Australian Stock Exchange\(^1\) over the period 2005-2015. The number of companies in the sample ranges from 1,489 in 2005 to a peak of 1,861 in 2011, declining to 1,745 in 2015.

Our sample period covers the years 2005-2015. Implicitly we note three sub-periods in the analyses:

1. the pre-2007 period, which is the period before the onset of the GFC;
2. the period 2008-2010, which is the period during the GFC, although Australia has outperformed economically compared to most of the other developed nations; and
3. the period 2011-2015, which represents the period more remote from the direct GFC impact; however, we note that this period includes a slowdown in Chinese economic growth commencing in 2011 and parts of the mining boom after 2011, together with a decline in the Australian Dollar against the USD.

Although Australia has recorded 21 years of consistent economic growth with no recessions since 1993\(^2\), the Australian economy has weakened since 2011-2012 with warnings of slower economic growth, primarily due to the slowdown of Chinese investment and the mining boom, competitive pressure on manufacturers, and other uncertainties regarding real growth in the economy.

Over this period, ASIC’s areas of focus for financial reports included ensuring that directors were realistic about their assumption about the entity’s future obligations and that auditors should carefully consider their reporting obligations with respect to the going concern assumption.\(^3\) ASIC (2012) also raised the issue of the need for auditors to consider sufficient and appropriate evidence in assessing the appropriateness of the going concern assumption and in particular with regard to mining and energy entities (ASIC 2012, page 16).

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\(1\) Companies with audit opinions signed outside Australia are excluded from our analysis.

\(2\) Source: thediplomat.com/2014/03/australias-economic-luck-21-years-and-counting/ See also “Economic growth at slowest pace since 2011”, www.afr.com/p/national/economic_growth_at_slowest_pace_gAvwQX2EzosdWC9sWYd2BL

\(3\) See ASIC’s areas of focus for 30 June 2011 financial reports MR11-139 (7 July 2011), 31 December 2012 financial reports MR12-292 (27 November 2012), and 31 December 2013 financial reports MR13-293 (30 October 2013).
# 3. Types of Auditor’s Reports

## 3.1 Auditing Standards and Classification of Auditor’s Reports

Current requirements for auditor’s reports in Australia are set out in ASA 700, ASA 705, ASA 706, and ASA 701, which replaced the pre-existing ASA 702 as a result of the clarity project, focus on the modifications to the audit opinion and EoM paragraphs and Other Matter paragraphs respectively. Compliance with the current Auditing Standards enables compliance with the corresponding International Standards on Auditing (ISAs). Based on the definitions employed in current Auditing Standards, we classify the audit opinions into modified opinions and unmodified opinions. Unmodified opinions are further divided into unmodified and unmodified with an EoM paragraph. Modified opinions are further categorised as except for, adverse opinion, and disclaimer of opinion. Modified opinions may also contain an EoM paragraph. To be consistent with the Australian Auditing Standards, we use the same terminology as used in ASA700, ASA705 and ASA706.

### Unmodified vs Modified Opinion

Based on ASA 700, the audit opinion is firstly classified as either an unmodified opinion or a modified opinion.

- **Unmodified opinion:** Under normal circumstances when the auditor concludes that the financial report is prepared, in all material respects, in accordance with the applicable financial reporting framework, the auditor shall express an unmodified opinion (ASA 700.16).

- **Modified opinion:** If the auditor concludes that the financial report, as a whole, is not free from material misstatement or if the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial report as a whole is free from material misstatement, the auditor shall modify the opinion (ASA 700.17).

### Types of Modified Opinions

Once an audit opinion is modified, three types of modified opinions are established for use in ASA 705, including a qualified (Except for) opinion, an adverse opinion, and a disclaimer of opinion.

- **Except for:** The auditor shall issue a qualified opinion when there is (are) material but not pervasive misstatement(s), or when the possible effects of the inability of the auditor to obtain sufficient appropriate audit evidence on the financial report of undetected misstatements are concluded as material but not pervasive (ASA 705.7). “Except for” statement is required in the Basis for Qualified Opinion paragraph (ASA 705.23).

- **Adverse opinion:** An adverse opinion shall be expressed if the auditor concludes the individual and/or the aggregated misstatements are both material and pervasive (ASA 705.8).

- **Disclaimer of opinion:** If a limitation on the scope is validated due to the auditor’s inability to obtain sufficient appropriate audit evidence and its possible effects on the financial report of undetected misstatements is both material and pervasive, the auditor shall issue a disclaimer of opinion. Another situation for a disclaimer of opinion is in extremely rare circumstances involving multiple uncertainties, when the auditor concludes that it is not possible to form an opinion due to the potential interaction and the cumulative effects of the uncertainties on the financial report.

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1. For the period covered by this report (2005-2015), the auditing standards on audit opinions have been substantially revised from the initial AUS 702 Audit Report on a General Purpose Financial Report (operative until 1 July 2006), ASA 700 (operative on or after 1 January 2006 due to the requirements of CLERP 9 Act that codify Australian Auditing Standards as legislative instruments), to the current ASA 700 that has been revised and redrafted by using the equivalent “clarity” versions of the International Standards on Auditing (ISAs) as the underlying standards (operative on or after 1 January 2010).  
2. ASA 701 Modifications to the auditor’s report was effective from 1 July 2006, and then replaced by ASA 705 and ASA 706 as a part of the “clarity” project in 2009, effective from 1 January 2010.  
3. We note that in December 2015, the AUASB revised ASA 700, ASA 705 and ASA 706 and implemented ASA 701, operative for financial reporting periods ending on or after 15 December 2016. The changes to the auditing standards include: a new standard on communicating key audit matters (ASA 701), changes to the descriptions of responsibilities of both management and auditors, and a greater focus on consideration of disclosures in financial statements.  
4. “Subject to” phrases are not appropriate for a qualified opinion as these are regarded as insufficiently clear or forceful (ASA 705. A22 (2010)).
EMPHASIS OF MATTER PARAGRAPH

An EoM paragraph shall be used when the auditor considers it necessary to draw user’s attention to a matter presented or disclosed in the financial report that, in the auditor’s judgement, is of such importance that it is fundamental to users’ understanding of the financial report (ASA 706.6). The auditor shall include an EoM paragraph to draw attention to the additional disclosures when the financial report has been prepared in accordance with Australian Accounting Standards but necessarily additional disclosures have been made in the financial report to ensure the financial report as a whole is comparable and understandable (ASA 706. Aus7.1). An EoM paragraph can be included in an unmodified or a modified auditor’s report.

3.2 AUDITING STANDARDS ON EMPHASIS OF MATTER PARAGRAPHS

Before ASA706 became effective in 2010, EoM paragraphs were governed by ASA701 which outlined the following circumstances in which an EoM paragraph is required:

• Material Uncertainty – Going Concern
• Material Uncertainty – Other
• Material Uncertainty – Going Concern and Other
• Additional Disclosures
• Inconsistent Other Information
• Subsequent Events Resulting in a New Auditor’s Report on a Revised Financial Report
• Other Reporting Responsibilities

Under ASA 706, operative for financial reporting periods commencing on or after 1 January 2010 the circumstances under which an EoM paragraph was appropriate were amended as follows:

• ASA 706.A1 identifies three types of circumstances in which an EoM paragraph may be necessary including
  1. an uncertainty relating to the future outcome of exceptional litigation or regulatory action,
  2. early application (where permitted) of a new accounting standard (for example, a new Australian Accounting Standard) that has a pervasive effect on the financial report in advance of its effective date, and
  3. a major catastrophe that has had, or continues to have, a significant effect on the entity’s financial position. An uncertainty, if its resolution may materially affect the financial report, would warrant an EoM paragraph in the auditor’s report (ASA 706. Aus A1.1).

• ASA 706 lists four Auditing Standards where circumstances may arise which require an EoM paragraph to be included in the auditor’s report (ASA 706. Appendix 1). These are:
  1. ASA 210 Agreeing the Terms of Audit Engagements – paragraph 19(b),
  2. ASA 560 Subsequent Events – paragraphs 12(b) and 16,
  3. ASA 570 Going Concern – paragraph 19, and
  4. ASA 800 Special Considerations—Audits of Financial Reports Prepared in Accordance with Special Purpose Frameworks – paragraph 14. Of relevance for our study is that going concern has been identified as a typical circumstance for an EoM paragraph.

• In addition, ASA 706 requires auditors to disclose a paragraph in the auditor’s report, with the heading “Other Matter,” or other appropriate heading if necessary.

An EoM paragraph does not indicate a modification to the auditor’s opinion or affect the auditor’s opinion (ASA 706.7(d), ASA706.A3-A4). As stated in ASA 706.A2, a widespread use of EoM paragraphs diminishes the effectiveness of the auditor’s communication of such matters; and unnecessarily excessive information in the EoM paragraph may imply that the matter has not been properly presented or disclosed.
4. TRENDS IN AUDITOR’S REPORTS

4.1 TYPES OF AUDITOR’S REPORTS

Table 1 Panel A shows the distribution of auditor’s reports classified by type of audit opinion for the period 2005-2015. Figure 1 (on page 4) graphs data from Table 1 Panel A to highlight the declining trend in unmodified reports and the increasing trend in the use of an EoM paragraph.

This table shows:

- There is a declining trend of unmodified auditor’s reports with no EoM paragraph (“standard auditor’s report”) over the period, dropping from 84.75% in 2005 to 62.98% in 2015. Compared with the pre-2007 period in which the percentage of standard auditor’s reports is around 85%, there is a relatively large drop in the percentage of standard auditor’s reports in 2008 (to 77.77%), corresponding with the onset of the GFC. This trend has not reversed [2009 (73.25%), 2010 (74.54%), 2011 (75.39%), 2012 (70.59%)] with the proportion declining further in 2013 (64.29%), 2014 (63.64%) and 2015 (62.98%).
- The decline in the ratio of standard auditor’s reports is mainly attributable to the increase in the auditor’s reports unmodified with EoM paragraphs, rising from 12.96% in 2005 to 33.64% in 2015.

4.2 TYPES OF EMPHASIS OF MATTER PARAGRAPH

Table 1 Panel B shows the types of EoM paragraph issued in 2005-2015. As discussed above there is a change on EoM paragraph in the standards, from ASA701 to ASA706 in 2010, with our study period prior to 2010 covered by ASA701 (2005-2010). We classify the types of EoMs in accordance with the ASA701 classifications in Table 1 Panel B. Figure 2 highlights that the majority of the EoMs are associated with going concern issues.

- For the period 2005-2007, 80%-90% of EoMs are due to going concern related uncertainty; the ratio surges to 94.93% in 2008 and stays over 90% after 2009. From 2012 onwards, the ratio of EoMs in relation to going concern increases to more than 95%.
- Except for the circumstances associated with material uncertainties (including uncertainties on going concern, and uncertainties other than going concern), other types of EoMs are rarely observed in the study period.

Figure 2. Types of Emphasis of Matter and/or Other Matter Paragraphs 2005-2015
5. GOING CONCERN

5.1 AUDITING STANDARDS ON GOING CONCERN

Under the going concern assumption, an entity is viewed as continuing in business for the foreseeable future. A general purpose financial report is prepared on a going concern basis, unless management either intends to liquidate the entity or to cease operations, or has no realistic alternative but to do so. When the use of the going concern assumption is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realise its assets and discharge its liabilities in the normal course of business (ASA 570.2).

Going concern uncertainty can be associated with an unmodified opinion, an unmodified opinion with an EoM paragraph, a qualified opinion, an adverse opinion, or a disclaimer of opinion. The determination of the appropriate audit opinion is based on consideration as to whether the going concern uncertainty is material, whether the use of the going concern assumption is still appropriate, whether the disclosure is adequate, and/or whether there is a limitation of scope imposed by the management to obtain sufficient appropriate audit evidence on going concern. Specifically, in regard to:

- **An unmodified opinion with an EoM paragraph on going concern**
  - An unmodified opinion with an EoM paragraph on going concern uncertainty shall be expressed when material going concern uncertainty exists while the auditor concludes that the going concern assumption is appropriately used and the adequate disclosure has been made (ASA 570.18 & 570.19).
  - An unmodified opinion with an EoM paragraph on alternative basis other than going concern assumption is appropriate if the going concern assumption is not appropriate and the management has prepared the financial report on an appropriate alternative basis with adequate disclosure (ASA 570. A26).

- **A modified opinion in relation to going concern**
  - A qualified opinion or an adverse opinion on going concern uncertainty shall be issued if the going concern assumption is appropriate with the appearance of material going concern uncertainty, but the disclosure of the material uncertainty in the financial report is not adequate (ASA 570.20).
  - An adverse opinion shall be expressed if the financial report has been prepared on a going concern basis but, the use of going concern assumption is inappropriate (ASA 570. 21).
  - A qualified or disclaimer of opinion may be appropriate due to management’s unwillingness to make or extend their going concern assessments when these assessments are necessary to provide additional audit evidence (including considerations of mitigating factors) in determination of whether a material going concern uncertainty exists and the auditor has requested the management to do so (ASA 570.A27).
  - A disclaimer of opinion may be considered appropriate instead of adding an EoM paragraph due to multiple material uncertainties on going concern are involved that are significant to the financial report as a whole (ASA 570.A22 & ASA 705).
5.2 REPORTS WITH GOING CONCERN RELATED ISSUES

Table 1 Panel C and Figure 3 shows the distribution of going concern related opinions across the years. The going concern related opinions are classified into modified in relation to going concern, and unmodified with EoMs on going concern. The Table shows:

- In 2005-2007, the percentage of going concern related auditor’s reports is stable at around 12%, with the majority of these being unmodified with an EoM paragraph on going concern.
- Over the period 2008-2010, the percentage of going concern related auditor’s reports increases to around 22%, consistent with the occurrence of the GFC and its associated economic impact on Australian entities.
- There is an increasing trend in going concern related auditor’s reports for the period 2011-2015 with a peak in 2015 of 34.73%. We speculate that it is attributable to the pause of the mining boom and the slowdown of China’s economic growth, and their impact on Australian Economy, or alternatively, a conservative response by auditors to the increased inspection activity by ASIC, but further investigation is needed.
- For the study period, a modified opinion on going concern is available but rarely used by the auditing practitioners.

Figure 3. Going Concern Related Reports: Qualification and Emphasis of Matter Paragraphs 2005-2015

5.3. AUDITOR’S REPORTS ISSUED BY DIFFERENT AUDIT FIRMS

Table 2 and Figure 4 report the types of auditor’s reports over the period 2005-2015 for Big 4 and non-Big 4 audit firms. Big 4 firms include the four largest international accounting firms, including: PricewaterhouseCoopers, Ernst and Young, KPMG and Deloitte. All other accounting firms are classified as non-Big 4 firms. We define going concern reports to include both going concern related modifications and EoMs, labelled as going concern in the figures.

- Over the study period, the percentage of modified opinions and the percentage of unmodified with EoMs are lower for Big 4 audit firms, compared to the percentages for these types of auditor’s reports issued by non-Big 4 firms.
• Big 4 audit firms:
  − For the period 2005-2007, the percentage of unmodified with EoMs is steady at around 7%; the ratio rises to over 13% in 2008 and remains stable over the years 2008-2011; in 2012 and 2013, the ratio jumps again to 17% and 20% respectively but drops back in 2014 and 2015 to around 18%.
  − There is no significant change in the percentage of modified opinions issued by Big 4 audit firms throughout the period, ranging between 0.5% and 2%.

• Non-Big 4 audit firms:
  − For the period 2005-2007, the percentage of unmodified with EoMs ranges from 15% to 19%; the percentage increases to 22%-27% for the period 2008-2011 and 30%-42% in 2012-2014. The year 2015 reports the highest percentage of unmodified with EoMs at 43%.
  − The percentage of modified opinions issued by Non-Big 4 firms is around 3%-7% over the years.

• Non-Big 4 firms report significantly higher rate of going concern reports (which include both modifications and EoMs), compared to the Big 4 group. Moreover, the gap seems to have increased during the past decade.
  − For 2005-2007, Big 4 firms report around 7% going concern reports; while Non-Big 4 firms issue around 15%-18% of their clients with going concern reports.
  − In 2008-2011, Big 4 firms issue around 15% going concern reports; while Non-Big 4s issued going concern reports to 25% of their clients.
  − In 2012-2015, the percentages for Big 4 firms are around 18-21%; for the same years, the percentages for Non-Big 4s are 32.5% in 2012 and then increasing to 45% in 2015.

Figure 4. Types of Auditor’s Report: Big 4 Accounting Firms vs. Non-Big 4 Accounting Firms 2005-2015
We would expect that the primary difference in reporting pattern between Big 4 and non-Big 4 firms is due to the differences in client size as Big 4 firms tend to have a client base with a larger average size and lower levels of risk (Xu et al. 2011).

5.4 TYPES OF AUDITOR’S REPORTS BY ENTITY SIZE

Table 3 and Figure 5 investigate the reporting patterns of entities of different size. The sampled listed companies are divided into groups of the largest 200, middle, and smallest 500 companies based on their total assets.

Figure 5. Auditor’s Reports with Going Concern Related Modifications and Emphasis of Matter Paragraphs by Entity Total Assets

Findings:

• As would be expected, entity size is strongly associated with the likelihood of receiving a report modified for going concern uncertainty. By their nature, small companies have less financial flexibility to respond to macro- and micro-economic changes. Generally, small companies (smallest 500) report a much higher percentage of auditor’s reports modified for going concern issues (average 41.84%) than the other two groups; large companies (largest 200, 2.86%).
• Largest 200 companies:
  − The percentage of going concern reports for the largest 200 companies ranges from 0% in 2005 and 2006, to the peak of 6%-7% in 2008 and 2009. The ratio declines quickly after the GFC period to 2.5% in 2011, and declines to 1.5% in 2013 and 2014 before increasing in 2015 to 4.5%.

• Middle companies:
  − The ratio of going concern reports for the middle group of companies has consistently increased from 2005 (6.97%) to 2009 (17.67%). After a slight drop in 2011 (14.90%), the ratio rises again to around 28% from 2013 onward.

• Smallest 500 companies:
  − For the smallest 500 companies, the lowest ratio of going concern reports is in 2007 (19.20%) and peaks in 2015 (61.0%). Similar to the category of middle companies, there are significant increases in the ratio in 2008, 2012 and 2013. These increases warrant further investigation of the underlying factors leading to this significant increase in auditor’s reports including going concern related modifications and EoMs.

• Overall, the trend of the three categories of companies by size shows similar pattern: the first significant rise in 2008, corresponding to the occurrence of the GFC, and the second rise around 2011 or 2012, corresponding to the slowdown of Australian economy and the increase in ASIC’s inspection activities, with a continuation of this level through to 2015. Specifically, large companies have been influenced significantly by the GFC but do not appear to have been heavily influenced by the recent local economic slowdown. For small companies the uncertainty of continuing as a going concern increases with both the GFC and the recent local context.

5. 5 TYPES OF AUDITOR’S REPORTS BY INDUSTRY

Table 4 summarises the types of auditor’s reports by industry and by year. The trends are summarised in Figure 6, with the following findings:

• Energy and Materials show a consistent upward trend in terms of going concern modifications and EoMs. ASIC (2012) warned that entities in the mining and energy industries are of high risk when auditors are assessing the going concern assumption. Our data supports this view and indicate that the two industries sensitively respond to the economic changes, e.g., the GFC (2008) and the suspected pause of mining boom (since 2011).

• Financial industry reports the highest unmodified rate and the lowest modification rate and the lowest rate of going concern related modifications and EoMs over the study period. Australia’s financial industry has been marked with the stable financial system and the most profitable banks in the world. We attribute the low modification and going concern related modifications and EoMs ratios to the strong Australian financial system and the outperformance of Australian banks during the recent years. However, we still observe an increased modification rate during the GFC period (2007-2009).

• Industrials, Consumer Discretionary, Consumer Staples, Health Care and Utilities display a similar trend with an increase in going concern related modifications and EoMs around the GFC. Consumer Discretionary, Consumer Staples, Health Care and Utilities then report a decrease in going concern related modifications and EoMs after 2013.

• Telecommunications industry is notable for its downward trend in unmodified with going concern related EoMs and modifications, which is opposite to most other industries.

Figure 6. Types of Auditor’s Report by Industry
6.4 CONSUMER DISCRETIONARY

6.5 CONSUMER STAPLES

6.6 HEALTH CARE
6.7 FINANCIALS

6.8 INFORMATION TECHNOLOGY

6.9 TELECOMMUNICATION
6.10 UTILITIES

- GC
- Modified
- EoMs
- Unmodified


0% 20% 40% 60% 80% 100%
6. AUDIT OPINION OUTCOMES

There are two ways in which auditors can simplistically be considered to have issued the “wrong” type of audit opinion.

The first is where an auditor’s report with a going concern related modification or EoM is issued, but the company does not subsequently fail in the next 12 months. This is called a Type 1 misclassification. Users of financial statements have been warned of going concern uncertainty. The Type 1 misclassification rate is an indicator of the proportion of companies receiving such auditor’s reports that subsequently fail. As companies do not fail immediately, we report the proportion of companies that delist within the next two years following the reporting date.

The second way, which is much more serious, is where an auditor does not flag a going concern issue with a modification or EoM, but the company fails. This is referred to as a Type 2 misclassification. Again, we examine the proportion of companies that delist within two years of audit reporting date. Companies can delist for a range of reasons so the proportion of delisting companies where there has not been a prior going concern related modification or EoM issued provides only a general indicator of the frequency of companies that have failed or have otherwise delisted without a prior going concern warning. Changes over time in this rate may however indicate concern as to whether auditors are providing sufficient warning regarding going concern uncertainty.

Table 5 and Figure 7 outline the trends in each type of misclassification for a sample of financially stressed firms (defined as firms with negative net income or negative operating cash flow) over the period 2005-2014. We further remove observations with incomplete financial or stock market data, foreign companies and financial institutions from the sample analysed.

As shown in Table 5 and Figure 7, for the period 2005-2014, Australian market has generally observed an upward trend in Type 1 misclassifications, increasing from 20% in 2005 to 46% in 2014, and a downward trend in Type 2 misclassifications, decreasing from 89% in 2005 to 23% in 2014.

- For 2005-2007, Type 1 misclassification ratios were maintained under 20% and Type 2 misclassifications were over 80%. Both Type 1 and Type 2 misclassifications display downward trends, while the downward slope for Type 2 misclassifications is steeper, suggesting increased auditor’s report accuracy before the GFC.

- In 2008 in response to the GFC, Type 1 misclassifications increased to 28% and maintained at this level through to 2010. For the same period, Type 2 misclassifications dropped in 2008 to 74% and then increased to 82% for 2009 and 2010.

- After 2011, in response to the pause in the mining boom, the slowdown of Chinese economy, and the increased pressure to the audit profession from ASIC audit inspections, Type 2 misclassifications decreased to 23% in 2014. For the same period, Type 1 misclassification kept on increasing to over 40% in 2013 and 2014. In 2014, the detected Type 1 ratio (where companies are issued with going concern related modifications and EoMs but do not subsequently delist) has been higher than Type 2 ratio (where subsequently delisted companies are not issued with a prior going concern related modification or EoM).

The overall decreasing trend in Type 2 misclassifications suggests that Australian auditors are increasingly providing going concern warnings through a going concern related modification or EoM for companies in financial distress which subsequently delist. On the other hand, the increase in Type 1 misclassifications may also indicate increased conservatism of the audit profession associated with the increased engagement risk from the changing economic environment and regulatory environment.

Although the relevant period for the purposes of assessing a company’s ability to continue as a going concern is the 12 month period after the audit report date, we examine a two year window after the financial year in which the going concern related modification and EoM is issued to allow for the lag in timing for disclosure and subsequent delisting of companies from the ASX. We use the two year criteria because the official delisting (including initial suspension with subsequent delisting) is often delayed relative to the first indications of business failure.
We also note that Type 1 misclassification rates must be interpreted with some caution. Because the overwhelming majority of going concern related auditor’s reports are unmodified EoM reports, a company receiving such a report not failing within twelve months of report date, is not a measure of auditor reporting error. We believe that the misclassification rate can be considered as an indication of report informativeness, but the misclassification rate should not be interpreted as an auditor error.

Figure 7. Type 1 and Type 2 Misclassification Analysis
7. CONCLUSION

This report presents our analysis of Australian auditor’s reports for the period 2005 – 2015 with the following points coming to our attention:

- As expected there is a surge in going concern related modifications and EoMs in 2008, attributable to the onset of the GFC.
- Another notable surge in going concern-related modifications and EoMs rates is observed in 2012 and 2013. At this stage, we speculate that it is attributable to reduced growth prospects arising from China’s economic slowdown, higher exchange rates and the ‘pause in mining boom’ since 2011. The graphs on job vacancies and unemployment rate over the last 30 years (available in the Appendix) seem to support this view.
- An additional explanation for the increase in going concern rates around 2012 is the increase in the activity and scope of ASIC’s inspection of audit firms in this period. We refer the interested reader to Carson, Fargher and Zhang (2016) for a multivariate analysis controlling for client and auditor characteristics.
- Although there are multiple reasons for EoMs available in ASA 706, the going concern issue is the issue that is referenced most frequently in explanations for EoMs.
- Big 4 audit firms report significantly lower ratio of going concern related modifications and EoMs than the non-Big 4 audit firms, probably attributable to the difference in their client size and characteristics. This gap does seem to have increased during the past decade.
- Large companies have been influenced significantly by the GFC but not heavily influenced by the recent local economic slowdown. The issuance of EoM for going concern for small companies increases for both the global crisis and the local economic slowdown.
- The pattern of auditor’s reports differs in terms of the industry category. Energy and materials industries have experienced a generally consistent increase in reports with an EoM for going concern. The two industries have been identified by ASIC as being highly risky in relation to the appropriateness of the going concern assumption (ASIC, 2012). The Financial industry has been notably strong over the period, reporting the lowest going concern related modifications and EoMs ratios, and the highest unmodified percentages.
- Associated with the increase in going concern related modifications and EoMs, Type 1 misclassification rates have increased. More importantly, Type 2 misclassification rates have fallen, suggesting auditors are increasingly able to identify companies which will subsequently delist from the ASX.
REFERENCES


Auditing and Assurance Standards Board (AUASB), 2013a, Auditing Standard ASA 570: Going Concern.


### DATA TABLES

#### TABLE 1 PANEL A: TYPES OF AUDIT OPINIONS 2005-2015

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#### TABLE 1 PANEL B: TYPES OF EMPHASIS OF MATTER AND/OR OTHER MATTER PARAGRAPHS 2005-2015

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#### TABLE 1 PANEL C: AUDIT REPORTS REGARDING GOING CONCERN 2005-2015

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#### TABLE 2 TYPES OF AUDITOR’S REPORTS FOR BIG 4 AND NON-BIG 4 FIRMS

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TABLE 4 TYPES OF AUDIT REPORTS BY INDUSTRY 2005-2015

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TABLE 4 TYPES OF AUDIT REPORTS BY INDUSTRY 2005-2015

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TABLE 5 TYPE 1 & TYPE 2 MISCLASSIFICATION ANALYSIS

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APPENDIX 1: ECONOMIC TRENDS IN AUSTRALIA

The seasonally adjusted unemployment rate since 1978

![Unemployment Rate Graph](image1)

The number of job vacancies (thousands) since 1979

![Job Vacancies Graph](image2)

Source: Australian Bureau of Statistics (ABS)