Summary of Research Project

Going Concern – Who is Concerned?

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The going concern assumption is fundamental to accounting and the basis of financial reporting. Ensuring the continued operation of a firm on a going concern basis is also the essential task for managers, and thus closely related to the firm's corporate governance mechanism. I propose to study, in the setting of a regulation change, of how going concern uncertainties disclosed by managers could lead to changes in a firm's corporate governance structure and whether such disclosure can help to predict firm bankruptcy and financial distress.

For U.S. firms, until recently it has mainly been the auditor's responsibility to assess a firm's going concern uncertainty. Now such responsibility has fallen upon the shoulder of managers. ASU 2014-15, the accounting standard update issued by FASB in August 2014, requires firms to disclose, in the notes to the financial statements, any uncertainties about the entity's ability to continue as a going concern. Managers should evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the entity's ability to continue as a going concern within one year after the financial statement issuing date. The changes proposed in ASU 2014-15 are effective for annual periods ending after December 15, 2016, and for annual periods and interim periods thereafter. I intend to use this setting to examine two main research questions.

The first research question is related to whether and how the disclosure of going concern uncertainties provided by managers could lead to changes in a firm's corporate governance structure. Disclosure and corporate governance are interlinked. Financial reporting serves as an effective tool to discipline managers and to improve the efficiency of corporate governance. Accounting provides the information required for most governance mechanisms to operate efficiently (Sloan 2001). After ASU 2014-15, managers are required to assess, on a quarterly basis, their firms' operating conditions and prospects and disclose to investors any issues related to going concern. Generally, managers have a self-serving bias to avoid disclosing unfavorable information (e.g. Kothari et al. 2009a). As going concern uncertainties manifest as one form of extremely negative corporate news, managers would prefer not to disclose any going concern uncertainties to the largest extent possible. Given such managerial incentive, it is likely that the enhanced disclosure under ASU 2014–15 could lead to an improvement in the corporate governance mechanism. The level of improvement in the corporate governance is likely to be associated with the quality of the new disclosure. To test it, I intend to conduct textual analysis on the new disclosures required by ASU 2014-15, including exploring the length, specificity, and topics in the new disclosures, and examine how does the level of improvement in the corporate governance vary with different linguistic characteristics.

The second research question is whether such disclosure can contribute to improving the precision of predicting financial distress and firm bankruptcy. The audit serves as a monitoring device and is thus part of the corporate governance mosaic (Cohen, Krishnamoorthy, and Wright 2002). However, the auditor's going concern opinion has been criticized as uninformative as it suffers from both type I and type II errors. Auditors can be reluctant to issue going concern opinions for the fear of losing their clients. For example, prior study finds that the greater the percentage of affiliated directors on the audit committee, the lower the probability the auditor will issue a going-concern report (Carcello and Neal 2003). In contrast, the manager's discussion of going concern uncertainties could be more informative because managers are required to assess relevant conditions or events every quarter, more frequent compared with the auditor's going concern opinion being issued annually. In addition, managers possess more inside information and are thus in a better position to evaluate their firms' operating conditions and prospects.

I will conduct empirical research to examine the above research questions. I've started extracting managers' disclosure of going concern uncertainties from the notes of 10-K and 10-Q filings, which are downloadable from the SEC website. I will then employ a difference-in-differences research design as the setting involves a change in accounting regulation. By doing so, this study could shed lights on the causal explanations of the research questions.

The proposed study can contribute significantly to the furtherance of good governance from the following perspectives. First of all, securing a firm's continued operation on a going concern basis is one of the main objectives of a robust corporate governance system. Second, the going concern assumption is the basis of financial reporting and disclosure; mandating a going concern requirement was the top agenda for accounting standard setters. Testing whether the additional disclosure provided under the new accounting standard could improve the efficiency of corporate governance and firm bankruptcy prediction can be useful to accounting standard setters, regulators, and all stakeholders in the capital market. Third, investors have started questioning the sufficiency of only having auditors' going concern opinion as an alert when firms are in financial distress, especially in the aftermath of the financial crisis. This study would help to address such investors' concern. Finally, this study will be the first attempt to employ the setting and use the data associated with ASU 2014-15. The study will contribute to our understanding of disclosure, governance, and going concern related issues. Given the connection and similarity of U.S. and Canadian capital market, such study would also be of interest to both U.S. and Canadian entities.

Reference

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