Credit ratings & the auditor’s going-concern opinion : the interplay of information intermediaries’ signals

Valorization

Capital markets are the foundation of today's economies. In order for firms to produce goods and services that are valuable to society, these firms need funding. This can be acquired at capital markets, where investors choose firms to invest in, hoping that they will receive a return on their investments. Yet, investors need credible information about firms in order to understand the business concepts and associated risks of the firms they would like to invest in. As investors often lose money if they have invested in firms that file for bankruptcy, a particularly important question is whether a firm is likely to continue as a going-concern, i.e. whether it is likely to operate in the foreseeable future and survive the next fiscal year. Firms who would like to acquire financing therefore have incentives to publish information about their past performance as well as the prospects of their firm in order to convince investors that their firm is a good investment. Yet, firms are unwilling to disclose information that could harm their competitive position. Moreover, there are some challenges for investors to evaluate the publicly disclosed information. First, firms have incentives to present themselves favorably and it is thus questionable whether investors can trust the presented information. Secondly, even if the information itself is trustworthy, investors often lack the necessary time and skills to evaluate the information.

In order to address the first issue, regulators have stipulated rules to ensure that the information provided by firms is credible. One of these rules is that auditors need to attest whether the information presented in the annual financial report is reflective of the underlying firm situation and whether the company is likely to continue to operate in the foreseeable future. If the firm is unlikely to survive the next fiscal year, auditors are required to issue a going-concern opinion (GCO). The challenge for firms to communicate their quality without losing their competitive advantage is remediated by other third party information intermediaries. While firms are hesitant to disclose sensitive information publicly, they are often willing to provide access to information intermediaries, like credit rating agencies, who can then publish a summary assessment of the firm's quality to investors without releasing the underlying proprietary information directly. Given the reputation of the information intermediary and the assessment of the firm, investors thereby acquire credible information about a firm's prospects. Besides information intermediaries with access to proprietary information, other information intermediaries exist, such as equity analysts, that do not have access to proprietary information, but their experience and expertise as well as their coverage of entire industries, allows them to provide investors with an expert opinion regarding the future prospects of a firm. Information intermediaries also solve the issue that investors lack time and skills to evaluate firms themselves as investors can incorporate the professional assessment of these information intermediaries in their decision.

The information intermediaries that are examined in detail in this dissertation are mainly auditors and credit rating agencies. Auditors are required to provide investors with an annual assessment whether the assumption that the assessed firm is likely to be able to continue to operate in the next fiscal year is viable. If the auditor believes that this assumption is violated, they issue a going-concern opinion. Besides the going-concern opinion that provides an assessment regarding the firm’s future health, other information intermediaries exist that also provides signals regarding a firm’s health. Credit rating agencies for example, evaluate the likelihood that a firm is able and willing to repay its debt in accordance with the terms of this debt. Their assessment is summarized and communicated via a credit rating. If a firm is unlikely to survive the next fiscal year, it is also unlikely that the firm will be able to repay all its debt and the credit rating is most likely downgraded. Besides auditors and credit rating agencies, one chapter of this dissertation additionally considers another type of information intermediaries, namely equity analysts. Equity analysts also gather and analyze information about a firm and communicate their assessment about the prospects of the firm via investment recommendations, earnings forecasts and target price forecasts. If a firm’s performance is deteriorating, analysts usually communicate this via negative investment recommendations or downward revisions of forecasts.

To date, extensive research exists that analyses how different information intermediaries and their signals directly impact the behavior by stakeholders internal or external to firms. Questions that are frequently addressed are for example, how information is disseminated by firms themselves and how investors, i.e. shareholders and creditors, react to such information. Another question that has been examined in depth in the academic literature is how market participants react to information that is provided by information intermediaries. However, questions that have not been examined extensively and that are therefore addressed in this dissertation are what the effect is that information intermediaries have on each other and whether and how investors react to these interactions.

The results of this dissertation imply that auditors incorporate credit ratings by professional credit rating agencies into their assessment whether the firm will continue to operate in the foreseeable future and alter their behavior to issue going-concern opinions in response to recent credit rating downgrades. This finding is examined in more detail in a later chapter of the dissertation and the results seem to be driven by the fact that auditors become more conservative as a result of a recent credit rating downgrade. This seems only natural because a more conservative assessment reduces the likelihood of potential lawsuits against the auditor. While credit ratings overall seem to increase auditor conservatism and do not necessarily improve the auditor’s assessment, auditors without expertise in their client's industry seem to benefit from credit rating changes as they are less likely to misjudge whether the firm is likely to continue operating beyond the next fiscal year when a credit rating change precedes. Besides considering the impact of these information intermediaries on each other, this dissertation also examines whether investors' reaction to the auditor's assessment is different depending on preceding signals by other information intermediaries. The results suggest that equity investors continue to value the auditor's assessment regarding a firm's future viability, even if it is preceded by signals from other information intermediaries like credit rating agencies and equity analysts that provide similar information. Only when these other signals are without ambiguity that a firm is unlikely to survive the next fiscal year, is the auditor's assessment not valued anymore.

These findings do not only provide an academic contribution, but they are moreover relevant for multiple public debates and therefore also to regulators. First, the auditor's report has been criticized for its lack of timeliness because it is only published on an annual basis. Opponents have argued that there are more timely indicators and that the auditor's assessment regarding the viability of firms is therefore redundant. Yet, the findings of this dissertation show that investors value the information provided by the auditor even if other professional information intermediaries, like credit rating agencies and equity analysts, provide more timely signals regarding a firm's future viability. This is interesting for regulators because it clearly shows that the auditor's opinion is not redundant and regulators might want to consider this in future regulatory changes.

Secondly, the auditor's assessment whether the company is likely to survive the next fiscal year has been criticized for its binary nature and its standardized wording. The findings of this dissertation show that investors value specifically this assessment. While there are other indications about a firm's future prospects that are not of binary nature, investors seem to derive value from the auditor's assessment because of its binary nature and standardized wording as exactly this seems to reduce ambiguity. This is also relevant for regulators with respect to the current debate regarding whether and how to restructure the auditor's report. Based on requests from stakeholders, particularly investors and financial statement analysts, to improve the informativeness of the auditor's report, the International Auditing and Assurance Standard Board (IAASB) is currently considering to restructure the auditor's report. More particularly, investors and financial statement users argue that the auditor's report is the only means by which auditors can communicate information about a firm to the public and therefore it would be helpful if the auditor's report would have more information. While the findings of this dissertation do not provide an assessment regarding whether the audit report should include more information or not, the findings show that it is important to maintain the clear format of the auditor's opinion regarding the future viability of a firm. This confirms the decision of the IAASB to add additional information to the auditor's report but to keep the unambiguous nature of the going-concern opinion.

Another public debate that is currently taking place is the role of credit ratings. Until the recent financial crisis, credit ratings were considered important information tools regarding firms' creditworthiness. They were not only used as guide concerning which firms to invest in by investors, but they were also incorporated in several capital market regulations. While an extensive stream of literature examines the role of credit ratings to investors and to firms, few research exists so far that considers the role of credit ratings for other information intermediaries, such as auditors. Given the auditor's litigation concerns and the fact that the assessment whether the firm is viable in the near future are often difficult, it seems only likely that auditors use other available information in their assessments. The findings of this dissertation show a clear association between credit rating changes and auditor's assessment regarding the future viability of those firms. This is important to consider for regulators as well, as it shows that changes to regulations of credit ratings might also indirectly affect auditors' actions. It is particularly important to understand that recent credit rating downgrades seem to increase auditor conservatism. Regulatory changes applicable to credit rating agencies to adapt credit ratings more quickly or to provide more conservative ratings, would likely result in auditors becoming more conservative overall as the findings of this dissertation imply. This is critical as this dissertation suggests that auditors occasionally become too conservative and regulators might want to consider the trade-off between more timely and more conservative credit ratings on the one hand and a side effect of more volatile ratings and potentially too conservative audit reports on the other hand.

Besides the implications for regulators, the findings of this dissertation are also relevant for auditors. This dissertation shows a strong association between credit rating downgrades and an auditor's propensity to issue going-concern opinions. It is important for auditors to understand how their decision is being affected by credit rating agencies and how credit rating agencies arrive at their rating. This is particularly relevant in light of the finding that auditors become more careful but not necessarily better in a going-concern assessment that follows a credit rating downgrade. The additional analyses with respect to auditors without expertise in their client's industry might be interesting and helpful for these auditors because it seems as if these auditor can derive additional information from credit rating changes and therefore improve their likelihood to give an assessment that is *ex post* identified as correct. Auditors should be aware of how their judgment is influenced by other information intermediaries in order to ensure that their decision regarding the assessment of the firm's future viability is indeed a conscious and hopefully optimal one.

Moreover, the findings are relevant to credit rating agencies themselves as it is important that they do not only understand the direct effects that their credit rating actions and reports have but also the indirect implications that their actions have on the end consumer of their reports via other market participants. Previous research has shown that investors react to changes in credit ratings immediately. Additionally, this dissertation implies that audit reports are also affected by credit rating changes. This means that investors are affected by credit rating changes directly but also indirectly via audit reports. Credit rating agencies need to be aware of these implications in order to ensure that their rating actions have indeed the intended consequences.

Last but not least, this dissertation might be useful to the users of audit reports and credit ratings. Clearly, there are implications for equity investors that decide whether they want to invest in a firm or not. For them it is relevant to be informed if a firm cannot continue to operate. It might therefore be interesting to understand how the auditor's decision whether to issue a going-concern opinion or not is influenced by actions from credit rating agencies. This is potentially particularly important in situations in which an auditor might be too conservative because investors might end up withdrawing their investments at a loss while it might not have been necessary (yet). Other users of audit reports such as a firm's creditors, employees, customers or suppliers might also find this interesting and relevant.

The increased awareness amongst all stakeholders – including regulators, auditors, credit rating agencies, and investors– to understand the indirect effects that signals by different information intermediaries have on each other might help to improve stakeholder actions and could thereby make capital markets overall more efficient.