Evidence on the Effect of Financial Distress on Type II Audit Errors

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ABSTRACT

Prior research studies have examined the relationship between corporate bankruptcies and prior audit opinions in the period following Sarbanes-Oxley and have generally found an increase in the auditor's likelihood of issuing going-concern audit opinions for corporate clients that subsequently declare bankruptcy. This increase in the auditor's likelihood of issuing a going concern opinion post-Sarbanes-Oxley has been interpreted as an increase in the level of auditor conservatism. However, prior studies have often limited their analysis of going-concern audit effectiveness to firms that were already in financial distress and have failed to specifically address the extent to which varying levels of financial distress affects the auditor's propensity to issue a going-concern audit opinion. This raises the main research question addressed in this study: Does the level of increased auditor conservatism post-Sarbanes-Oxley, (i.e., the increase in going concern opinions for bankrupt firms) differ for distressed versus non-distressed firms, and more specifically, ***to what extent do varying levels of financial distress affect auditor conservatism?***

For all companies filing Chapter 11 bankruptcy between 1997 and September 30, 2009, SEC filings are examined to determine the existence of a going concern opinion for the fiscal year immediately preceding the year of bankruptcy. Financial information from the Compustat database is then used to measure the level of "financial distress" for each company prior to bankruptcy. Based on prior research, financial distress is measured using the following alternative variables: Altman's Z'-Score, Altman's Z" Score, the Hopwood et al. (1994) bankruptcy probability score, and the Zmijewski et al. (1984) bankruptcy probability score. Using logistic regression, the current study examines the relationship between Type II audit errors and the level of financial distress, and also compares this relationship pre-versus-post Sarbanes-Oxley. Results of this study: (a) address the limitations in prior research that has examined the relationship between financial distress and Type II audit errors, (b) provide evidence on the extent to which varying levels of financial distress affects auditor conservatism, and (3) provide evidence on the extent to which this particular aspect of auditor conservatism has been impacted by Sarbanes-Oxley.

References available upon request.