The Association Between the Internal Control and Going Concern Audit Opinions—Take the Case of AT Co., Ltd

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Abstract. Since the promulgation of the Sarbanes-Oxley Act, corporate internal control has received increasing attention from all stakeholders. For the auditor, internal control audit opinion also generates additional information content, having a significant impact on the auditor's other audit decisions. However, the impact of internal control audit opinion on going-concern audit opinion has received little attention. Therefore, the purpose of this study is to examine the relationship between internal control audit opinion and going-concern audit opinion. The descriptive analysis of listed companies in stock markets of Shanghai and Shenzhen in 2016 and the case analysis of AT Group Co., Ltd. helped drawing the conclusion that, for enterprises in financial distress, non-standard internal control audit opinion will increase the possibility of the issuance of the going-concern audit opinion.

Introduction

With the development of external auditing, both in the system-centric era and in the risk-oriented period, the impact of internal control on audit risk is particularly vital. Studies have shown that there is a significant correlation between internal control audit opinion and financial statement audit opinion. According to the research of Altamuro (2010), the quality of internal control and the quality of financial statements are positively related, so the internal control weaknesses will increase the possibility of auditors issuing negative financial statement audit opinions. However, previous studies often divided five kinds of financial statement audit opinions into two types, standard audit opinion and non-standard audit opinion, and were easy to ignore that non-standard audit opinion can also be divided into two types, going-concern audit opinion (GCO) and the else. From 2014 to 2016, non-standard audit opinion resulting from the uncertainty of enterprise's going-concern ability respectively accounted for about 50% of the total number of non-standard audit opinions. Therefore, the uncertainty of companies' going-concern ability became the main reason for the GCO.

GCO is one of the basic assumptions of accounting, referring to audit opinions that explicitly mention the uncertainty of the firm's going-concern ability by the auditors. As the continued operation is the basis for the preparation of financial reports, if the company receives a GCO from the auditor, it will also receive a non-standard audit opinion. Therefore, in some studies on non-standard audit opinions, scholars rarely distinguish between GCO and the else, ignoring the heterogeneity of GCO and non-standard audit opinion. BENG WEE GOH and DAN LI (2013) pointed out that for enterprises in financial distress, if the internal control has material weaknesses, the auditor will lower its "threshold" of the issuance of the GCO. In order to discuss the relationship between the internal control audit opinion and the GCO, this paper analyzes the information content of the internal control audit opinion and the theory of CPA’s occupational risk avoidance. In addition, through descriptive analysis and case study, this paper studied the relationship between the internal control audit opinion and the GCO.
Theoretical Analysis

Information Content of the ICO

Theory of information asymmetry holds that there is information asymmetry between the operator of the company and the external stakeholders, and the latter are prone to "moral hazard" and "adverse selection". Thus, the disclosure of the audit report by CPA can convey more information to stakeholders outside the enterprise, to a certain extent, reducing the asymmetry of information. Chen Hanwen and Dong Wang (2010) argues that, as part of the audit report, the disclosure of internal control information can effectively alleviate the problem of information asymmetry. In other words, the disclosure of internal control audit information plays the role of information transmission, alleviating moral hazard and adverse selection.

Although the CPA does not directly benefit from the audit information, the improvement in the quality of the audit and the reduction of the audit risk are equally favorable. Therefore, the CPA is also one of the stakeholders outside the enterprise. Considering the audit quality and audit risk, the auditor will still be aware of the impact of the internal control audit opinion on the judgment of the firm's going-concern ability. In other words, the internal control audit opinion also plays a role of signal transmission to the GCO audit judgment. For enterprises that are already in financial distress, receiving an non-standard internal control audit opinion (ICO) means that there is clear internal control weaknesses, in the future fiscal year, making the enterprise's going-concern ability more difficult to improve. Studies such as Kim, Song, and Zhang (2011) show that the ICO significantly increases the financing costs and make it harder for firms in financial distress to finance. This shows that, for companies in financial difficulties, the ICO increases the possibility of the issuance of the GCO.

Occupational Risk Avoidance of CPAs

Since the 21st century, the Enron and other big companies repeatedly exposed financial scandals. At the same time, internal control really got the attention of enterprises and the community. With the continuous development and implementation of the internal control system, the occurrence of financial fraud has been effectively controlled. There is no doubt that the quality of internal control directly determines the authenticity and reliability of corporate accounting information. From the audit risk formula, if the internal control system is obviously flawed or cannot work effectively, the control risk will break out, increasing both the audit risk and the enterprise's own litigation risk.

For CPAs, internal control weaknesses also increase their litigation risk. Study by Geiger and Raghunandan (2002) shows that when auditors face higher litigation risks, they will be more conservative in judging the going-concern ability. In other words, if the enterprise receives the ICO, both the enterprise itself and the auditor will face greater risk of litigation. Therefore, in order to minimize their own practice risk, CPAs will be more likely to issue the GCO to enterprise in financial difficulties.

Descriptive Analysis

Overall Trend

In 2016, 110 listed companies in stock markets of Shanghai and Shenzhen received the ICO, and 52 listed companies have been issued with the GCO. Among them, there were 16 listed companies receiving both the ICO and the GCO, accounting for 14.55% of the number of companies issued by the ICO. But on the whole, in all listed companies in stock markets of Shanghai and Shenzhen, the number of those issued by the GCO accounted for only 1.65%. Therefore, we can infer that, compared with the overall incidence of the GCO, firms with the ICO are more likely to receive the GCO and the incidence is much higher than the overall incidence of the GCO. After calculation and comparison, it can be found that the trend remains unchanged from 2014 to 2016, as shown in table 1.
Table 1. Impact of the ICO on the incidence of the GCO.

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<th>2014</th>
<th>2015</th>
<th>2016</th>
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<tr>
<td>Overall incidence of the GCO</td>
<td>1.74%</td>
<td>1.90%</td>
<td>1.65%</td>
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<td>Incidence of the GCO for companies with the ICO</td>
<td>24.05%</td>
<td>15.60%</td>
<td>14.55%</td>
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**Industry Characteristics**

In 2016, in listed companies receiving the GCO in stock markets of Shanghai and Shenzhen, manufacturing, wholesale and retailing and real estate accounted for the top three proportions, followed by 75.00%, 5.77% and 3.85%. Among them, manufacturing accounted for much higher than other industries, and the figure in 2014 to 2016 are maintained at around 70%. According to statistics, in all listed companies in stock markets of Shanghai and Shenzhen, the overall proportion of manufacturing enterprises reached 61% in 2016, which to some extent can explain the phenomenon that in listed companies with the GCO in stock markets of Shanghai and Shenzhen, manufacturing enterprises always account for a higher proportion.

Further study found that, in the case of the ICO issued by auditors, Chemical raw materials and chemical manufacturing companies (sub-categories of manufacturing) may be more likely to receive the GCO than other manufacturing companies. From 2014 to 2016, companies of the industry in stock markets of Shanghai and Shenzhen respectively accounted for 10.87%, 12.96% and 11.54% of all enterprises receiving the GCO. However, for firms receiving the ICO and the GCO at the same time, the ratios were 15.79%, 23.53% and 18.75%. This shows that for chemical raw materials and chemical products manufacturing industry, the existence of the ICO may make the incidence of the GCO increase by 50% or more. The reason for this phenomenon is complex, but it is closely related with the industry overcapacity and environmental pressures.

**Case analysis Based on AT Co., Ltd**

**Judgment Basis of the GCO**

AT Group Co., Ltd.'s business scope includes the production and sale of coke, pig iron, power carbon products, chemical products, etc., belonging to the ferrous metal smelting and processing industry. Nearly three years, the industry’s overcapacity problem was serious, along with environmental pressures and the downturn of futures market, steel and coke prices continued to shock. Besides, the firm's own poor profitability and higher financial leverage made the financial pressure grow. Therefore, its operating performance was poor in nearly three years. Moreover, AT Group Co., Ltd. has a high degree of equity concentration and a small balance of equity, which is one of the reasons for the low quality of the company's internal control. As shown in Table 2, from 2014 to 2016, the cash outflow from operating activities was large and the cash recovery was not effectively controlled. In addition, the short-term solvency of AT Co., Ltd had deteriorated. These factors together constitute the judgment basis of the GCO issued by auditors.

Table 2. Part of the Financial Situation Data Unit: RMB.

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<th>Year</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
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<tr>
<td>Net profit attributable to shareholders</td>
<td>-680,314,834.53</td>
<td>37,899,162.53</td>
<td>-581,954,801.85</td>
</tr>
<tr>
<td>Net cash flow from operating activities</td>
<td>-754,889,758.87</td>
<td>-334,254,738.89</td>
<td>-128,395,365.53</td>
</tr>
<tr>
<td>Liquidity ratio</td>
<td>161.73%</td>
<td>73.15%</td>
<td>66.05%</td>
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**Analysis of the ICO**

From the information disclosed by Lixin Certified Public Accountants and the Shanghai Stock Exchange, the reason why AT Group Co., Ltd. continued to receive the ICO in 2014 and 2016 is that a serious event of related-party capital occupation occurred in 2014, and up to now, adverse effects of
the incident have not been eliminated. Specifically, in 2014, when XT Co., Ltd. failed to pay the selling funds to AT Co., Ltd. in accordance with the agreed time, AT Group Co., Ltd. still sold goods to XT Co., Ltd. (the related party of the major shareholder). A large account of receivables formed and no information about that was disclosed by AT Group Co., Ltd. As at 31 December 2014, the balance of the receivables was RMB1.82 billion. In addition, in 2014, AT Group Co., Ltd. prepaid several suppliers for the purchase of raw materials, but the actual transaction did not exist. At December 31, 2014, the balance of above-mentioned prepaid raw materials purchase was RMB1.87 billion. Then, XT Co., Ltd. borrowed from the above-mentioned suppliers as a short-term loan, the balance of which was RMB1.77 billion.

From the view of five internal control elements, there were material weaknesses in AT Group Co., Ltd.’s internal control. In terms of internal environment, the concentrated ownership structure caused the weakening of the role of equity checks and balances. There is a suspicion that the actual controller and the high-level of AT Co., Ltd. colluded to implement the related-party capital occupation. In the case of risk assessment, when the related business was in financial distress and did not pay the sales funds on time as agreed, the operator still delivered a large amount of inventory to it. This indicates that AT Group Co. lacked a risk assessment of the operating level of the related party and neglected the large risk of bad debt in the accounts receivable. In the aspect of control activities, the company paid a substantial prepayment to the supplier in the absence of a real transaction, exposing the failure of its approval process for the use of funds. In terms of information and communication, the company did not disclose the large receivables according to the relevant laws, reflecting the lack of control of information disclosure, which was not conducive to the knowledge and supervision of stakeholders.

The Influence Path of the ICO on the GCO

Due to the ambiguity of the audit criteria and the limit of the implementation, in the evaluation of business going-concern ability, auditors need to rely on their own knowledge, experience and ability. Thus, the GCO has heterogeneity. For example, Zhang Xiaolan (2006) pointed out that the auditors may have the same audit opinion on companies with significantly different operations and different types of audit opinions on companies that do not have significant differences in going-concern ability. It is noteworthy that the question of CPA on the going-concern ability is based on financial difficulties of enterprises. In other words, if a firm does not have financial distress, the auditor will not doubt its ability of going-concern. However, not all businesses in financial distress will receive the GCO. The reason is that going-concern ability reflects the prediction of the financial status of firms in the next period. While some companies are temporarily in financial distress, if there is sufficient evidence that their financial distress can be significantly improved in the future, the auditor will decide whether or not to issue the GCO according to his or her professional judgment.

For AT Group Co., Ltd., operating conditions and financial data in nearly three years show that it has been in financial distress, undoubtedly forming a basis for judging the going-concern ability. Specifically, from the perspective of industry development, the industry was in a recession. Overall gross margin of this industry is low and even many companies lose money. In nearly three years, operating performance of AT Group Co., Ltd. was poor. Besides, the net cash flow from operating activities continued to be negative, listed as -754,889,758.87, -334,254,738.89 and -128,395,365.53 respectively (RMB). This shows that the operating activities of the company made net cash outflow. Without financing, the cash of AT Group Co., Ltd. will continue to decrease. Moreover, from 2014 to 2016, the liquidity ratios were respectively 161.73%, 73.15% and 66.05%, reflecting the deterioration of short-term solvency. Therefore, whether the business situation in the future can be improved will determine the issuance of GCO or not.

Among the factors that affect auditors' judgment, the quality of internal control plays a very important role. AT Group Co., Ltd. in 2014 and 2016 both received the ICO, disclosing material weaknesses of internal control. Besides, the existence of these material weaknesses of internal control will bring greater uncertainty to the improvement of the corporate's going-concern ability. Specifically, the business situation in 2014 and 2016 were poor and the net profits attributable to shareholders were negative. At that point, the existence of material weaknesses of internal control not
only increased the company's temporary financial pressure, but also brought the business much uncertainties in future operating. Therefore, in the presence of financial difficulties, the auditor takes into account the material weaknesses of internal control of AT Group Co., Ltd. and issued a GCO. The overall judgment process of the auditor is shown in Figure 1.

![Figure 1. Audit judgment of the GCO.](Image)

**Conclusion**

As the supervisor of accounting information and the transmission of economic information, the CPA shoulder increasing responsibility. Therefore, if the CPA cannot obtain sufficient evidence, he will bear a lot of practice risk. Auditors have no quantitative criteria in predicting customer’s going-concern ability and to some extent rely primarily on their own knowledge, experience and ability to make an audit judgment. This makes the auditors have to fully consider the various factors that may affect professional judgment. Among these factors, the impact of internal control audits on GCO is quite noteworthy. If the enterprise is already in financial trouble, internal control weaknesses will be detrimental to the future operation and financing. Therefore, considering their own practice risk, auditors tend to become more conservative, who may be more likely to issue the GCO to such enterprises.

**References**


