

**Management Turnaround Initiatives and Auditors' Going-Concern Judgment:  
Memory for Audit Evidence**

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## **ABSTRACT**

This study explores the effect of operating and strategic management plans on going-concern judgments for distressed firms. Prior archival going-concern research (e.g., Behn, Kaplan and Krumwiede, 2001) indicates that operating turnaround initiatives taken by a financially troubled firm (e.g., cost-cutting) have a negative impact on auditors' going-concern judgments, whereas strategic initiatives (e.g., new cooperative agreements with other firms) have a positive influence on auditors' going-concern judgments. We add to this research by examining the mechanisms through which implemented turnaround initiatives affect auditors' assessment of client viability. In particular, we study whether this type of information has a direct impact on going-concern judgment or whether it affects judgment indirectly through the subsequent processing of financial evidence. In addition, we investigate whether management turnaround initiatives have a differential influence on going-concern judgment for experienced and novice auditors.

The results of our experiment reveal a positive direct effect of strategic turnaround initiatives on going-concern judgment, whereas operating turnaround initiatives had no significant direct influence on the going-concern decision. The analysis of the indirect effect of management turnaround initiatives on going-concern judgment showed that experienced (but not novice) auditors who received information about management turnaround initiatives focused more on negative financial going-concern evidence than auditors who did not receive information about management turnaround initiatives.

# **Management Turnaround Initiatives and Auditors' Going-Concern Judgment: Memory for Audit Evidence**

## **I. INTRODUCTION**

Evaluating whether a client is a going concern is a complex judgment, especially if there are indications that the company is in financial distress. When a company experiences results that threaten its existence, auditing standards (SAS no. 59 and ISA 570) require an auditor to consider company plans to mitigate the adverse conditions, including operating or strategic actions taken by management. The increasing use of business risk audit methods may influence the manner in which turnaround initiatives are evaluated by an auditor since they cause the auditor to focus on strategic performance as part of audit planning (Bell, Marrs, Solomon and Thomas, 1997; Lemon, Tatum and Turley, 2000; Bell, Peecher and Solomon, 2005; Knechel, Salterio and Ballou, 2006). Prior archival research has shown that client operating and strategic actions to address financial distress may have diverse effects on an auditor's decision to issue a going concern opinion (Behn, Kaplan and Krumwiede, 2001; Geiger and Rama, 2003; and Bruynseels and Willekens, 2006). More specifically, operating initiatives which focus on internal firm problems (e.g., cost cutting) have been found to increase the likelihood of receiving a going-concern opinion. In contrast, initiatives that focus on external problems and are likely to generate near-term cash flows (e.g., new cooperative agreements with other firms) decrease the likelihood of receiving a going-concern opinion.

This study experimentally investigates how management turnaround initiatives influence auditor going-concern decisions involving a financially distressed firm. We argue that knowledge of client activities to mitigate financial distress can influence auditors' going-concern judgments both directly and indirectly. A direct effect occurs because the implementation of

management turnaround actions will cause the auditor's assessment of the likelihood of bankruptcy to change. An indirect effect occurs because an auditor's understanding of management actions may influence the evaluation of subsequent financial information. This latter effect is suggested by prior research which has found that the holistic perspective that auditors acquire when evaluating a client's strategic performance impacts the auditor's evaluation of subsequent evidence. For example, Ballou, Earley and Rich (2004) suggest that the auditor's evaluation of a client's strategic positioning affects the processing of information at the business-process level, while O'Donnell and Schultz (2005) demonstrate that strategic performance affects auditors' tolerance for inconsistent fluctuations in accounts, which in turn influences their account-level risk assessments. Furthermore, Salterio, Knechel and Kotchetova (2006) indicate that strategic analysis influences how auditors interpret performance measures, a common input to the going concern judgment of auditors.

In this study, we also investigate the influence of audit experience on auditors' consideration of client operating and strategic initiatives to mitigate adverse conditions. In particular, we propose that auditor experience moderates both the direct and indirect effect of turnaround information on going-concern judgment. Prior research indicates that information acquisition by inexperienced auditors is driven by the need to complete a task, while experienced auditors try to develop a thorough understanding of the client, the nature of its business and critical risks facing the organization (Biggs, Mock and Watkins, 1988; Biggs, Selfridge and Krupka, 1993). This suggests that the direct effect of turnaround initiatives on going-concern judgment might be more pervasive for experienced auditors, relative to novice auditors. Furthermore, we propose that the evaluation of client turnaround initiatives has differential consequences for the initial impression formation of the client for experienced and novice

auditors. Because this initial impression of the client is likely to influence the processing of subsequent client information, we expect the indirect effect of turnaround initiatives on going-concern judgment to be different for experienced and inexperienced auditors.

We conducted an experiment in which 97 experienced and novice auditors worked on a case involving a going-concern decision. The participants were randomly assigned to six experimental conditions created by crossing three levels of turnaround initiatives (Operating, Strategic, Control) with two levels of experience (Novice, Experienced).

The results show that, in general, strategic initiatives have a positive overall effect on going-concern judgment, whereas operating initiatives have no effect. When we examine the mechanisms through which implemented turnaround initiatives affect auditors' assessment of client viability. We find that strategic initiatives have a positive *direct* effect on the auditors' viability judgment, whereas operating initiatives have no direct effect on judgment. Using recall as a proxy for attention, we observed an *indirect* effect for experienced auditors who recalled more negative evidence cues when presented with information about either operating or strategic turnaround initiatives. Novices exhibit no significant indirect effects. These results suggest that management turnaround initiatives may serve as an "early warning signal" of client distress for experienced auditors which causes them to focus more on financial distress indicators in subsequent analysis. Taken together, the results indicate that both novices and experienced auditors consider strategic initiatives taken by management—but not operating initiatives—to increase the likelihood that a company will continue as a going concern. However, the existence of *any* management initiatives causes experienced auditors—but not novices—to analyze the situation more closely by considering other signs of financial distress more carefully.

The remainder of this paper is organized as follows. Section 2 describes the research framework used in this study and develops the hypotheses to be tested. In Section 3 we describe the research method. Section 4 presents the results of the experiment. Finally, in Section 5, we summarize the results and discuss the implications for auditing practice and further research.

## **II. RESEARCH FRAMEWORK AND HYPOTHESIS DEVELOPMENT**

Auditing standards (SAS No. 59 and IAS 570) require an auditor to evaluate conditions or events discovered during the engagement that raise questions about a company's financial health and ability to continue as a going concern. When an auditor initially concludes that there is substantial doubt about the continued existence of the entity as a going-concern, the auditor should identify and evaluate management's turnaround initiatives. However, the standards do not prescribe the performance of separate audit procedures solely to identify potential going-concern problems, i.e., the results of auditing procedures designed and performed to achieve other audit objectives should be sufficient for that purpose. This is consistent with Asare (1992), who notes that the going-concern task is performed contemporaneously with other tasks. Given the complexity and difficulty of the going-concern judgment, Rau and Moser (1999) argue that going-concern decisions are generally memory-based, i.e., auditors store going-concern information in long-term memory for subsequent retrieval. This is consistent with prior research which measured participants' evaluation of going-concern evidence using cue recalls (e.g., Choo and Trotman, 1991; Tan, 1995; Rau and Moser, 1999; Hoffman, Joe and Moser, 2003).

In this paper, we examine how auditors process information about client initiatives designed to mitigate financial distress and how this influences their evaluation and memory for subsequent financial going-concern evidence. The structure of the experiment used in this study is summarized in Figure 1. We presume a direct effect of turnaround initiatives on going concern

judgments as well as an indirect effect as manifested in the recall of evidence cues. In addition, we predict that the strength of the indirect effect of management turnaround initiatives is conditional on an auditor's level of experience.

Because prior research indicates that operating and strategic turnaround initiatives have a differential impact on auditors' going-concern decision, our research design incorporates two possible client initiatives: (1) implementation of a cost-cutting initiative that saves cash in the short term (Operating) and (2) negotiation of an alliance with another firm that has the effect of improving short-term cash flows (Strategic). In order to assess the net effect of different strategic initiatives, we compare auditor judgments in the Operating and Strategic conditions to a Control condition where participants received no information regarding current operating or strategic initiatives. The direct effect is depicted by path A, whereas path B and C reflect the indirect effect, i.e. the impact of turnaround initiatives on the evaluation of financial going-concern evidence, measured through recall of financial information items.

<<<<< Insert Figure 1 about here >>>>>

### **Path A: Direct Effect of Turnaround Initiatives on Going-Concern Judgments**

SAS no. 59 and IAS 570 explicitly require auditors to consider non-financial matters and mitigating management plans when making a going-concern decision. Moreover, the standards give examples of operating (e.g., cost-cutting initiatives) and strategic factors (e.g., loss of a key franchise or license) that are potentially useful as going-concern evidence. Thus, we expect auditors to take into account the mitigating or aggravating impact of management operating and strategic initiatives on client viability when making a going-concern decision.

Research in strategy suggests that operating and strategic initiatives have different implications for the potential success of a turnaround plan. Prior research that has focused on the efficacy of operating initiatives such as retrenchment has yielded mixed results. Some studies report that retrenchment activities (e.g., cost-cutting) contribute to turnaround success (e.g., Robbins and Pearce, 1992), while other studies cast doubt on the likely success of operating approaches for coping with financial distress (Barker and Mone, 1994; Sudarsanam and Lai, 2001). The mixed evidence from the strategy literature indicates that operating turnaround initiatives *per se* may be inadequate, given that a severely distressed firm's problems often relate to its strategic orientation (Barker and Duhaime, 1997). Given the evidence reported in the strategic literature, it is likely that auditors perceive short-term operating turnaround strategies such as cost-cutting as insufficient to induce recovery for distressed firms:

**H<sub>1A</sub>:** For financially distressed companies, the implementation of short-term operating turnaround initiatives has a *negative* direct effect on an auditor's going-concern judgment.

External strategic actions to cope with poor performance may be more difficult to implement but may also have a greater chance of success. Research has found that strategic initiatives are generally associated with success in a company turnaround. For example, Barker and Duhaime (1997) show that when a company's decline is due to firm-specific factors, recovering firms implement more extensive strategic changes. In addition, Sudarsanam and Lai (2001) indicate that firms recovering from financial distress typically adopt more forward-looking, expansionary and external market focused strategies than non-recovery firms. Given the evidence from the strategy literature about the effectiveness of strategic approaches for

company turnaround and recovery, it is reasonable to expect that such strategies may have a mitigating impact on the auditor's going-concern opinion<sup>1</sup>.

**H<sub>1B</sub>:** For financially distressed companies, the implementation of short-term strategic turnaround initiatives has a *positive* direct effect on an auditor's going-concern judgment.

#### *The moderating influence of experience on going-concern judgment*

Prior empirical auditing expertise research has indicated significant differences between experienced and inexperienced auditors with respect to knowledge, problem solving behavior and decision quality (Frederick and Libby, 1986; Bonner, 1990; Bonner and Lewis, 1990; Libby and Frederick, 1990; Frederick, 1991; Choo and Trotman, 1991; Tubbs, 1992; Bédard and Chi, 1993; Davis, 1996 and Shelton, 1999). The results of a study by Biggs et al. (1988) regarding analytical review indicate that there is a difference between managers and seniors in terms of their goals in acquiring information. For seniors, information acquisition is usually oriented towards obtaining the information needed to perform an assigned task. While this goal is also important to managers, much of their information acquisition activity is directed at developing a thorough understanding of the client, the nature of its business, and its most critical business risks. More specifically, Biggs et al. (1993) find that the going concern judgments of experienced auditors are influenced by their extensive knowledge of a client's operations, industry, and world events.

Moreover, prior research on the effect of auditor experience on going-concern decisions indicates that the well-developed knowledge structures of experienced auditors help them to consider not only information that is typical for a company with going-concern problems, but

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<sup>1</sup> As the auditor's going-concern opinion is an assessment of the client's ability to survive during the next 12 months, only those (long-term) strategic approaches that are expected to have a positive impact on the company's liquidity status *within* the next 12 months will be perceived as mitigating factors.

also information that is atypical, such as mitigating going-concern evidence items (Choo and Trotman, 1991; Hoffman et al., 2003). Experts are believed to organize knowledge so as to allow greater processing of relevant information. This increased processing capacity allows experts to better attend to atypical information that requires additional processing (Fiske, Kinder and Larter, 1983). In sum, this evidence suggests that an increased level of experience is predicted to have an increasing effect on auditors search and processing of information related to client turnaround initiatives:

**H<sub>2A</sub>:** Client operating initiatives will have a greater impact on going-concern decision-making for experienced auditors than novices.

**H<sub>2B</sub>:** Client strategic initiatives will have a greater impact on going-concern decision-making for experienced auditors than novices.

### **Path B: Effect of Turnaround Initiatives on recall of financial evidence**

Prior audit research has provided ample evidence that auditors' expectations and beliefs have a strong impact on their subsequent processing of consistent and inconsistent evidence (Ashton and Ashton, 1988; Tubbs and Messier, 1990; Bedard and Biggs, 1991; Church, 1991; Asare, 1992; McMillan and White, 1993 Tan, 1995 and Wilks, 2002). Therefore, information about a client's strategic and operating decisions might also have an indirect influence on auditor judgments since knowledge of a client's turnaround initiatives is likely to influence how an auditor subsequently interprets and recalls other client information (Bell et al., 1997; Knechel et al., 2006). More specifically, initial information about a client's strategic positioning and overall performance may affect an auditor's processing of subsequent information and memory for evidence.

The manner in which consistent and inconsistent information is processed by decision makers has been studied in social psychology using schematic models of impression formation

and encoding (e.g., Hastie, 1981; Stangor and McMillan, 1992). In general, an important attribute of schematic modeling is that individuals process information that is consistent with their expectations (referred to as *expectancy-congruent*) differently than they process information that is contrary to expectations (referred to as *expectancy-incongruent*). A general prediction that follows from this distinction is that individuals will prefer expectancy-congruent information and will be better able to recall such information in a decision situation. This prediction follows from two basic arguments: (1) expectancy-congruent information is easier to assimilate because it better fits the existing schema for an information context and will be more readily available in memory (Alba and Hasher, 1983) and (2) expectancy-incongruent information will be filtered out or reinterpreted to fit existing schema (Neisser, 1976). Thus, basic schema models of information processing suggest that auditors would be more able to retrieve expectancy-congruent information which would then have an impact on the judgments they make about whether a client is a going concern.

The Associative Network Model (Srull and Wyer, 1989) has extended the insights of basic schema modeling by providing a foundation for more specific predictions about how consistent and inconsistent information is used by decision makers. The model assumes that memorability of information is dependent on the extent to which it is mentally elaborated by the decision maker. Information inconsistent with expectations will be well remembered if the decision maker feels the need to make sense of the inconsistent information. In contrast, expectancy-congruent (consistent) information will be particularly well remembered if it supports the validity of initial expectations (Higgins and Bargh, 1987), and the decision maker is motivated to bolster the validity of these expectations (Srull and Wyer, 1989).

A critical question arises as to what audit evidence would be considered to be expectancy-congruent in the context of an auditor's going concern judgment, especially when management has undertaken one or more turnaround initiatives. Previously discussed research suggests that management operating initiatives such as cost-cutting initiatives *per se* are not sufficient to trigger a company turnaround and may rather reinforce the signal that the company faces going-concern problems. Therefore, an auditor is likely to assume a negative impression of a financially distressed company as a going concern if it undertakes only operating actions. As expectancy-congruent (consistent) information is expected to be particularly well remembered if it supports the validity of the decision maker's expectations (Higgins and Bargh, 1987), we expect subsequent negative financial information to be well remembered by the auditor. As a result, auditors will focus on negative evidence when a troubled company undertakes short term operating actions to stave off failure, leading to our next hypothesis:

**H<sub>3A</sub>:** When the client implements operating turnaround initiatives, an auditor will recall relatively more *negative* financial evidence cues in evaluating going-concern information.

The case of strategic turnaround initiatives is more complex. On one hand, prior research suggests that strategic responses to financial distress are more likely to result in a successful company turnaround so an auditor might adopt a positive impression when a client takes strategic initiatives. However, the mere fact that a client is financially distressed and needs to take a turnaround initiative may create a negative impression in the auditor. Following the reasoning in Srull and Wyer (1989), information inconsistent with expectations will be well remembered if the decision maker feels the need to make sense of the inconsistent information. In the context of strategic initiatives, we expect that subsequent negative information cues that are incongruent with the positive going-concern signal from the strategic initiative that has been

undertaken will be particularly well remembered since the auditor will attempt to resolve the inconsistent information. Given this reasoning we formulate the following hypothesis:

**H<sub>3B</sub>:** When the client implements short-term strategic turnaround initiatives, an auditor will recall relatively more *negative* financial evidence cues in evaluating going-concern information.

*The moderating influence of experience on recall of financial evidence*

Empirical evidence indicates that both novices and experts start the problem solving process with the formation of a mental representation of the problem which subsequently guides the development of a problem solving strategy. However, in contrast to novices, experts' categorization and solution of encountered problems is guided by their internal schemata which contain prototypical firm types, likely characteristics, etc. which are associated with certain problem situations. These schemata are typically activated by the data encountered early in the analysis and allow experts to perform goal-oriented information acquisition processes (Bouwman, Frishkoff and Frishkoff, 1987; Anderson, 1988). In contrast, novice decision-makers who lack these internal schemata are less likely to focus their attention to information most relevant to the problem and will include more (disjointed) information items in their evaluation (Lehman and Norman, 2006).

When we apply this to the setting where auditors learn early in the audit process that the client is implementing various turnaround initiatives, we expect that this information will trigger experienced auditors' internal schemata of a severely distressed client who potentially faces going-concern problems. Consequently, experienced auditors' information acquisition process is likely to focus on specific pieces of financial information indicative of client financial distress. In contrast, novice auditors who lack these internal schemata are not expected to adopt an information processing strategy focusing on the evaluation of financial health, but to process the

case information in a non-goal-oriented fashion (Biggs and Mock, 1983, Bouwman, 1984). As a consequence, when experienced auditors learn early in the audit process that the client is implementing operating or strategic initiatives to improve financial health, they will recall more financial evidence indicative of potential going-concern problems, relative to novice auditors.

**H<sub>4A</sub>:** When a client implements operating turnaround initiatives, experienced auditors will recall more negative financial evidence cues, relative to novice auditors.

**H<sub>4B</sub>:** When a client implements strategic turnaround initiatives, experienced auditors will recall more negative financial evidence cues, relative to novice auditors.

### **Path C: Effect of Recall of financial evidence on going-concern judgment**

In forming memory based judgments auditors will use all information that is seemingly diagnostic for the judgment, but necessarily limited to the information that is accessible in memory (Feldman and Lynch 1989). This explains why the factors that influence the nature of recalled information, will also influence the nature of the judgment that is based on this information. If operating and strategic initiatives have the predicted effect on cue recall, it follows logically that the cue recall will also affect the going concern rating assigned by an auditor. More specifically, auditors that recall more positive financial cues will likely have a more positive opinion about a company's chance of survival resulting in a higher going-concern rating relative to an auditor that recalls more negative financial cues. This argument leads to our third hypothesis:

**H<sub>5</sub>:** Auditor recall of financial evidence will be *positively* associated with going-concern judgment.<sup>2</sup>

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<sup>2</sup> In this context, a positive association means that auditors who recall more positive cues will provide a higher going concern rating while auditors who recall more negative cues will provide a lower going concern rating.

### **III. METHOD**

#### **Experimental Design**

To test these hypotheses, the study employs a 3 x 2 design. The independent variables are management actions in response to financial distress (Operating, Strategic, Control) and the level of auditor experience (Novice, Experienced). Client responses to financial distress were manipulated by providing participants in the strategic and operating conditions with a brief overview of current initiatives, reflecting either an operating or strategic turnaround approach. Participants in the control condition received no information with respect to current initiatives. Experience was manipulated as novice (students) or experienced (managers and partners).

We observed two sets of responses by participants during the course of the experiment: (1) participants' going-concern judgments and (2) evidence cues recalled. We collected recalled cues as a measure of participants' attention to going-concern evidence (e.g. Choo and Trotman, 1991; Libby and Trotman, 1993; Tan, 1995; Phillips, 1999; Rau and Moser, 1999). We measure the proportion of recalled positive cues (i.e., the number of recalled positive cues divided by the total number of positive and negative recalled cues) as a proxy for an auditor' relative attention to confirmatory and disconfirmatory evidence. The ratio of positive cues adjusts for any differences in the total number of positive and negative cues recalled across experimental conditions (Hoffman et al., 2003).

#### **Materials and Procedures**

##### Case Material

We developed a going-concern judgment case based on the 10-K filings of a financially distressed Canadian food retail company. The case reflected a company that was in near-distress, and which could be reasonably evaluated as either needing a going concern opinion or not. The

case materials were designed in close collaboration with a Big 4 auditing partner, who reviewed the case for reality and provided pertinent advice, and was subject to extensive pilot testing. Case materials were delivered through a web-based information system.<sup>3</sup> Each participant received an email containing a web address and a unique registration code. The participants were also provided with the opportunity to request a copy of the results of the study.

### Experimental Procedure

The experimental task consisted of six parts. Participants were asked to: (1) read company information, (2) complete a demographic questionnaire, (3) make a going-concern judgment, (4) perform a recall task, (5) make a strategic viability assessment, and (6) complete a debriefing questionnaire. Participants could not look ahead to subsequent parts of the case, or return to parts previously completed.

In the first phase of the experiment, participants were assigned to one of the three treatment conditions (strategic, operating, control) and were asked to assume the role of the newly appointed auditor of a large food retail company. They were asked to read the company information carefully because it would be used in subsequent parts of the exercise. The company information consisted of (1) company background and vision, (2) financial ratios for the previous and current year, (3) an unaudited balance sheet and income statement for the current year, (4) an audited balance sheet and income statement for the previous year, (5) actual and forecasted profit and cash flow, and (6) information regarding compliance with debt covenants. In the strategic and operating conditions, participants received additional information indicating that the company engaged in strategic alliances with other companies (strategic condition) or implemented a cost cutting plan (operating condition) in order to improve cash flow and restore

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<sup>3</sup> The experimental materials and case were in English.

earnings and sales growth. In both conditions, the case indicated that management actions were expected to increase net income by \$30 million. See Appendix 1 for an overview of the information contained in the section “current strategic initiatives and realisations”. The participants in the control condition did not receive any information with respect to current strategic initiatives. The responses of the third group provide a baseline against which the responses of the participants in the strategic and operating condition can be compared.

In the second phase of the experiment, participants were asked to fill in a demographic questionnaire related to their auditing background. The participants were asked to provide information with respect to their level of responsibility within the firm, the number of years of audit experience, the number of food retail clients audited in the past four years, and their industry specialisation (if any).

In the third phase of the experiment, participants judged the probability (likelihood) that the company would continue as a going-concern. Participants were asked to indicate their assessed probability that the company would continue as a going-concern in the coming year on a scale from 0 to 100, with end points labelled "Definitely Will Not Continue as a Viable Operation" and "Definitely Will Continue as a Viable Operation" (e.g., Asare, 1992; Rau and Moser, 1999; Shelton, 1999; Philips, 2002; Blay, 2005). Additionally, the participants were asked to judge their confidence in the going-concern decision on a scale from 0 (not confident at all) to 100 (entirely confident).

The fourth phase consisted of a recall task in which the participants were asked to list all the information they could remember about the company and the financial statements. After providing all recalled items, the participants were instructed to indicate for each recalled item whether it was positive, negative, or neutral in regard to company viability. We asked the

participants to indicate how they interpreted each cue they recalled because research by Moser (1992) has indicated that the participant's interpretation of recalled information items has more effect on their judgments than the experimenter's classifications. We measure subjects' relative attention to positive cues as the proportion of positive cues recalled (i.e. the number of positive cues recalled divided by the sum of positive and negative cues recalled) and refer to this measure as Proportional Recall.

In the fifth phase of the experiment, participants were asked to indicate the likelihood that the company would be able to execute its strategy successfully on a scale from 0 (definitely will not be successful) to 100 (definitely will be successful). They were also asked to indicate their confidence in their strategic viability assessment. To make sure that the participants took notice of the strategy of the company, we asked them to describe the company's current strategic initiatives.<sup>4</sup>

In the last phase of the experiment, participants were asked to complete a debriefing questionnaire which assessed their experience in making going-concern decisions and the extent to which they consider strategic information when assessing a company's ability to continue as a going-concern. The flow of tasks is described in Table 1.

<<<<< Insert Table 1 about here >>>>>

### Subjects

Two groups of participants participated in the experiment: experienced auditors and novice auditors. The experienced participants were auditors at the manager/partner level and were recruited from Western European Big 4 auditing firms. These participants were selected on the basis of discussions with audit firm partners who indicated that they would have sufficient

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<sup>4</sup> The responses indicated that all participants understood the strategy of the company.

experience in going-concern decision-making to perform the task at hand. Of the 89 auditors that were contacted, 56 responded to all questions and assessments (a response rate of 63%). The novice participants were 54 accounting majors who had completed an auditing course at a large Western European university.<sup>5</sup> The auditing course was taken as part of the entry exams to be admitted in an audit traineeship with an auditing firm. Seven observations were dropped from the sample because the participants appeared to have misunderstood the instructions. Another six observations were not included because the participants' did not list any financial evidence cues when asked to complete the recall task, which strongly suggests that they did not complete the experiment in a thorough manner. This resulted in a final sample of 50 experienced auditors and 47 novices. The experienced participants consisted of 19 partners and 31 managers.

Table 2 reports sample descriptive statistics for overall audit experience and specific experience making going-concern decisions for the experienced auditors. The statistics in Table 3 indicate that the experienced auditors had 13.4 years of audit experience, and audited one retail client in the past four years. Furthermore, ten percent of the experienced auditors indicated that they specialized in the audit of retail clients. With respect to experience in making going-concern decisions, on average, the participants made over eleven going-concern decisions for financially distressed clients over the most recent four years. None of the demographic results varied significantly across the treatments groups.

<<<<< Insert Table 2 about here >>>>>

Additionally, we compared the time experienced and novice auditors spent reading the company information and making the going-concern and strategic viability assessments. We

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<sup>5</sup> In prior research, accounting students have been used as a surrogate for novice auditors by, for example, Frederick and Libby (1986), Libby and Frederick (1990), Tubbs (1992), Anderson and Maletta (1994) Hoffman, Joe and Moser (2003) and Lehmann and Norman (2006).

performed t-tests for differences in means (not tabulated), which indicated no significant differences in the time spent on the different tasks between the strategic, operating and control condition.<sup>6</sup> Experienced auditors spent less time than novices reading the general company information ( $t = 3.07, p = 0.00$ ), the financial ratio information ( $t = 3.54, p = 0.00$ ), the strategic information ( $t = 2.68, p = 0.01$ ) and the financial information ( $t = 5.27, p = 0.00$ ). This is consistent with prior research, which indicates that experienced auditors perform more goal-oriented, directed evaluations of evidence, relative to novice auditors (e.g., Anderson, 1988; Bédard and Chi, 1993; Cuccia and McGill, 2000; Thibodeau, 2003). Furthermore, analysis reveals that experienced auditors allocated significantly more time to the assessment of the company's ability to continue as a going-concern ( $t = 1.86, p = 0.06$ ) relative to novice auditors.

#### IV. RESULTS

To test whether management turnaround initiatives influenced the going-concern decision directly or indirectly through memory for financial evidence, we used mediation analysis (Baron and Kenny, 1986). Proportional recall mediates the relation between turnaround initiatives and the going-concern decision if (1) turnaround initiatives are associated with proportional recall, (2) proportional recall is associated with the going-concern decision, and (3) after controlling for turnaround initiatives, the effect of turnaround initiatives on the going-concern decision is reduced. In the case that the relationship between turnaround initiatives becomes non-significant, full mediation is observed. However, we expect turnaround initiatives to have a direct effect on going-concern judgment in addition to the indirect effect through recall of financial information, which indicates partial mediation.

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<sup>6</sup> One exception is the reading of strategic information, which takes 0 seconds in the CONTROL condition.

In addition, we investigate the influence of experience on the nature of the direct and indirect effect by looking at the interaction between experience and turnaround initiatives on going-concern judgment (direct effect) and on recall of financial information (indirect effect).

### **The Total Effect of Management Turnaround Initiatives on Going-Concern Judgments**

To assess the extent to which the effect of turnaround initiatives on going-concern judgment is mediated by recall of financial evidence, we first analyze the total effect of management initiatives on going-concern judgment. Based on the findings from the archival literature on this topic, we expect to find that strategic initiatives reduce the likelihood that a going-concern opinion is issued, while operating turnaround initiatives have the opposite effect (see, Behn et al.; 2001; Geiger and Rama, 2003; and Bruynseels and Willekens, 2006). Moreover, we investigate whether the overall effect of management operating and strategic turnaround initiatives on going-concern judgment is different for experienced and novice auditors.

We assess the overall effect of management turnaround initiatives by performing an ANOVA with going-concern ratings as the dependent variable and turnaround initiatives (Strategic, Operating, Control) and experience (Experienced, Novice) as independent factors (see Table 3). Because we expect a different effect for both types of turnaround initiatives relative to the control condition, we also estimate *a priori* contrasts comparing the strategic and operating conditions to the control condition. To get an insight into the moderating effect of experience on going-concern judgments, we perform the contrasts analysis separately for experienced and novice auditors.

Although the ANOVA results indicate no significant effect of turnaround initiatives on going-concern judgment ( $F=1.87$ ,  $p<0.159$ ), the results of the contrast analysis indicates that the

going-concern judgments in the strategic condition are significantly more positive than those in the control condition ( $t=-1.63$ ,  $p<0.053$ , one-tailed). This result is consistent with the results from Bruynseels and Willekens (2006), who find that strategic initiatives with a short-term impact on cash flow generally send a positive signal to the auditor and hence decrease the likelihood that a going-concern opinion is issued (see also Behn et al., 2001; Geiger and Rama, 2003). Conversely, we do not find evidence of a negative effect of operating initiatives on going-concern judgment when compared to the control group ( $t=-0.16$ ,  $p<0.436$ , one-tailed). Examination of the contrast analysis for experienced and novice auditors reveals that novice auditors rated both the operating and strategic conditions as higher than the control condition, with the strategic condition being 11.65% higher than the control group ( $t=1.79$ ,  $p<.039$ , one-tail). Experienced auditors rate the operating condition as negative and the strategic condition as positive. Although neither effect is statistically different from the control group, the pattern is consistent with our hypotheses and the difference of 8.96% between the operating condition and the strategic condition is significant ( $t=-1.33$ ,  $p<.093$ ).

<<<<< Insert Table 3 about here >>>>>

### **Path B: The Effect of Management Turnaround Initiatives on Recall of Financial Evidence**

The indirect effect of management turnaround initiatives on going-concern judgment is composed of (1) the effect of management initiatives on financial cue recall and (2) the effect of financial cue recall on the going-concern rating. The impact of management initiatives on proportional recall is estimated using an ANOVA model with proportional recall as the dependent variable and experience and management initiatives as independent factors. Table 4 reports the mean proportional recall and going-concern judgments for experienced auditors and novices. In general, we see that experienced auditors recalled fewer positive financial cues in

both the strategic and operating conditions, relative to the control condition.<sup>7</sup> Experienced auditors also recalled more negative financial cues compared to novice auditors in the strategic and operating condition. However, in the control condition, experienced auditors recall more positive cues and fewer negative financial cues than novices. This pattern suggests that the experienced auditors generally have a more positive frame for judging going concern (Asare, 1993) than novices unless a client adopts actions that are construed as being in response to financial distress, in which case they are more negative regardless of the nature of management's initiatives.

<<<<< Insert Table 4 about here >>>>>

The results of the ANOVA are presented in Table 5. Neither experience or management initiatives is significant as a main effect for proportional recall of financial evidence (Panel B) but the interaction between both factors is significant ( $F=3.95$ ,  $p<.023$ ). These results suggest that management initiatives do not have an influence on proportional recall for the sample as a whole, which means that we cannot interpret the planned contrasts to examine H3a and H3b without considering the interaction effect between management initiatives and experience. For novices, the proportional recall of neither financial nor total cues in the control condition was statistically different from the comparable recall in the operating or strategic conditions. However, for experienced auditors, proportional recall of positive financial information in the control condition was significantly higher than the operating condition ( $p<.002$ , one-tailed). Additionally, experienced auditors had higher proportional recall of positive financial information in the control condition relative to the strategic condition ( $p<.019$ , one-tailed). This

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<sup>7</sup> We distinguish between financial and non-financial cues based on whether cues relate to financial ratios and financial company information or the company's business and history, industry information, vision and operating strategy and current strategic initiatives and realisations.

suggests that management initiatives, regardless of their nature, may have a negative indirect effect on the going-concern judgments of *experienced* auditors, which is consistent with hypothesis 4a and 4b.

<<<<< Insert Table 5 about here >>>>>

### **Path A and C: Effect of Management Turnaround Initiatives and Proportional Recall on Going-Concern Judgments**

We next estimate the strength of the direct and indirect effect of turnaround initiatives as well as the moderating influence of experience on the direct effect by performing an ANCOVA with the going-concern rating as the dependent variable, management initiatives and experience as independent variable, and the observed proportional recall as a co-variate. Partial mediation through recall is identified if the variable reflecting management initiatives is significant after controlling for proportional recall. In this case, management initiatives have a specific and direct effect on the going-concern decision in addition to their indirect effect through recall. In addition, the interaction between auditor experience and turnaround initiatives indicates whether experience also has a moderating influence on the direct effect.

The results of the ANCOVA are reported in Table 6. Management initiatives remain marginally significant when we include experience and financial recall in the analysis ( $p < .097$ ), suggesting that turnaround initiative have a direct effect on auditors' going-concern judgment. We test hypothesis 1a and 1b by estimating *a priori* contrasts for strategic and operating turnaround initiatives relative to the control condition. The results indicate that strategic turnaround initiatives have a positive direct effect on the going-concern decision ( $t = -2.05$ ,  $p = 0.022$ , one-tailed), which is consistent with hypothesis 1a. The contrast analysis also indicates that operating initiatives have no direct effect on the going-concern decision ( $t = -0.30$ ,  $p < .383$ ,

one-tailed), which contradicts hypothesis 1b. Proportional recall of financial evidence is positive and significant ( $F=11.30$ ,  $p<.002$ ), which provides strong support for H5. The interaction between experience and management initiatives is not significant. The contrast analysis shows that both novices and experienced auditors rate the going-concern judgment as more positive when the company undertakes strategic turnaround initiatives, although only the results for novices are statistically significant ( $t=-1.67$ ,  $p<.049$ ).

The combined results of table 3 and table 5 indicate that the direct effect is stronger than the overall effect. Although the direct effect is usually less strong than the total effect when mediation is observed, there are circumstances under which the strength of the direct effect exceeds the total effect. In particular, the total effect may be suppressed when the indirect effect has the opposite sign of the direct effect (Mac Kinnon, Krull and Lockwood, 2000; Shrout and Bolger, 2002). In fact, the total effect may even be close to zero if the strength of the direct effect is similar to the strength of the indirect effect. Because we hypothesized opposite signs for the direct and indirect effect for strategic turnaround initiatives, it is highly likely that the total effect of strategic initiatives on going-concern judgment is empirically weak due to this suppression process.

<<<<< Insert Table 6 about here >>>>>

## V. CONCLUSIONS

In this study, we extend prior archival research that examines the relationship between operating and strategic management plans and the auditor's going-concern decision. Recent studies on this topic (Behn et al., 2001; Geiger and Rama, 2003; Bruynseels and Willekens, 2006) indicate that operating management actions such as cost-cutting and strategic initiatives

with a short-term impact such as cooperative agreements with other firms have a significant impact on auditor going-concern decisions. We add to this body of research by investigating whether those management initiatives influence going-concern decisions *directly* or whether management initiatives affect going-concern judgment *indirectly* through memory for financial evidence. Moreover, we hypothesize that these direct and indirect effects are different for experienced and novice auditors.

The results of our analysis indicate that strategic management initiatives have an overall positive influence on going-concern judgments, whereas operating initiatives do not have a significant influence on the going-concern decision. When we decomposed this overall effect of management initiatives on going-concern judgment into a direct effect and an indirect effect through recall of financial evidence, the results revealed a positive direct effect of short-term strategic initiatives on going-concern judgment. However, contrary to our expectations, we found no evidence of a negative direct effect of operating turnaround initiatives on going-concern judgment and no evidence of a different direct effect for novice and experienced auditors. With respect to the indirect effect of management initiatives on cue recall, we predicted that both operating and strategic initiatives would lead to the recall of fewer (more) positive (negative) financial cues, and that this effect would be more pronounced for experienced auditors. Our analyses showed that the implementation of *both* types of management turnaround initiatives have a negative effect on cue recall for experienced auditors, but not for novice auditors. This can be explained by the fact that client implementation of turnaround initiatives activated experienced auditors' problem representation of a severely distressed firm, which caused experienced auditors to focus more on financial distress indicators in subsequent analysis. This effect is not likely to occur for novice auditors because they generally lack a well developed

problem representation of a firm facing going-concern problems to guide their processing of information. It is also interesting to note that in spite of being sensitized to more negative information, experienced auditors still rated companies undertaking strategic actions as having a better chance of survival relative to other firms.

This study is subject to a number of limitations. The first limitation that applies relates to the number of participants ( $n = 97$ ). The small sample size of this study is largely due to the fact we required half of the participant group to be audit partners or managers. A second limitation is that we included auditing students as novice auditors. Although these students are familiar with the concept of going-concern decision-making, it is possible that the absence of audit experience had an impact on the results of this study. Third, this study considers only the impact of cost-cutting initiatives and strategic alliances on going-concern judgment. As the results of previous research suggest that alternative turnaround initiatives such as increased marketing efforts or acquisitions of other companies are also likely to have a significant impact on the going-concern decision (Bruynseels and Willekens, 2006), it would be interesting to analyze the impact of a variety of turnaround initiatives on going-concern decisions.

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FIGURE 1  
Hypothesized relation between client turnaround initiatives, experience, memory for going-concern evidence and the going-concern opinion.

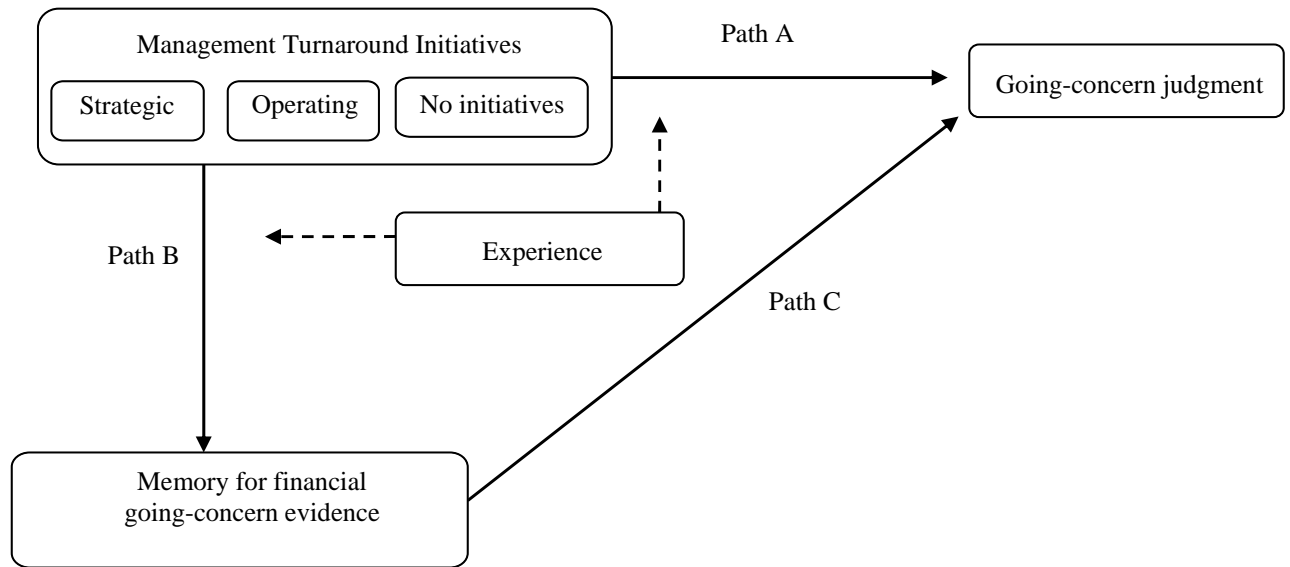


TABLE 1  
Flow of tasks

	Strategic	Operating	Control
Phase 1	Read company info:	Read company info:	Read company info:
	<ul style="list-style-type: none"> <li>• Business and history</li> <li>• Industry information</li> <li>• Vision and operating strategy</li> </ul>	<ul style="list-style-type: none"> <li>• Business and history</li> <li>• Industry information</li> <li>• Vision and operating strategy</li> </ul>	<ul style="list-style-type: none"> <li>• Business and history</li> <li>• Industry information</li> <li>• Vision and operating strategy</li> </ul>
	<ul style="list-style-type: none"> <li>• Financial ratios</li> <li>• Current strategic initiatives and realisations (strategic alliances)</li> </ul>	<ul style="list-style-type: none"> <li>• Financial ratios</li> <li>• Current strategic initiatives and realisations (cost-cutting)</li> </ul>	<ul style="list-style-type: none"> <li>• Financial ratios</li> </ul>
	<ul style="list-style-type: none"> <li>• Financial company information</li> </ul>	<ul style="list-style-type: none"> <li>• Financial company information</li> </ul>	<ul style="list-style-type: none"> <li>• Financial company information</li> </ul>
Phase 2	Demographic questions	Demographic questions	Demographic questions
Phase 3	Going-concern judgment	Going-concern judgment	Going-concern judgment
Phase 4	Recall task	Recall task	Recall task
Phase 5	Strategic assessment	Strategic assessment	Strategic assessment
Phase 6	Debriefing questions	Debriefing questions	Debriefing questions

Strategic = experimental condition where participants received information with respect to client strategic turnaround initiatives

Operating = experimental condition where participants received information with respect to client operating turnaround initiatives

Control = experimental condition where participants received no information with respect to client turnaround initiatives

TABLE 2:  
 Mean (standard deviation) of measures of audit and going-concern decision-making experience

Management initiatives	n	Audit experience	Retail experience	Retail specialists	Going-concern experience
Operating	15	12.00 (7.38)	0.80 (1.01)	0.13 (0.35)	10.97 (7.49)
Strategic	17	15.85 (2.32)	0.59 (1.12)	0.06 (0.24)	9.65 (6.09)
Control	18	12.19 (1.47)	1.50 (3.54)	0.11 (0.33)	8.39 (7.49)
Total	50	13.38 (1.12)	0.98 (2.28)	0.10 (0.30)	11.39 (14.81)

Audit experience = years of audit experience

Retail experience = number of food retail clients audited in the last four years

Retail specialists = dummy variable indicating whether the participant is a self-designated retail specialist

Going-concern experience = number of going-concern judgments over the last four years.

Strategic = experimental condition where participants received information with respect to client strategic turnaround initiatives

Operating = experimental condition where participants received information with respect to client operating turnaround initiatives

Control = experimental condition where participants received no information with respect to client turnaround initiatives

TABLE 3  
Overall effect of Turnaround Initiatives and Experience on Going-Concern Judgment

<i>Panel A: Analysis of Variance</i>			
Source of Variation	df	F-statistic	P-value
<b>Main Effects</b>			
Experience	1	1.33	0.253
Initiatives	2	1.87	0.159
<b>Interaction</b>			
Experience*Initiatives	2	0.65	0.526
 <i>Panel B: Comparisons of Going-Concern Judgments</i>			
Contrast	Effect size	T-statistic	P-value <sup>a</sup>
Control vs. Operating	-0.78	-0.16	0.436
Control vs. Strategic	-7.45	-1.63	0.053*
<b>Experienced:</b>			
Control vs. Operating	-5.72	-0.86	0.196
Control vs. Strategic	3.26	0.51	0.307
<b>Novice</b>			
Control vs. Operating	4.16	0.59	0.277
Control vs. Strategic	11.65	1.79	0.039**

<sup>a</sup>one-tailed

\*\*\* indicate significance at the .10, .05 and .01 level, respectively.

Going-concern judgment = probability that the company will continue on a scale from 0 to 100

Initiatives = turnaround condition (Strategic, Operating, Control)

Experience = level of experience (Novice, Experienced)

Strategic = experimental condition where participants received information with respect to client strategic turnaround initiatives

Operating = experimental condition where participants received information with respect to client operating turnaround initiatives

Control = experimental condition where participants received no information with respect to client turnaround initiatives

TABLE 4:  
Mean number (standard deviation) of items recalled, memory measures and going-concern judgments

Management Initiatives	N	Total Cues	Positive Cues <sup>a</sup>	Negative Cues <sup>a</sup>	Positive Financial Cues <sup>a</sup>	Negative Financial Cues <sup>a</sup>	Proportional recall <sup>b</sup>	Going-Concern Judgments <sup>c</sup>
Experienced auditors								
Operating	15	5.27 (1.67)	1.33 (1.50)	3.93 (1.71)	0.47 (0.64)	3.33 (1.59)	0.17 (0.28)	53.67 (19.50)
Strategic	17	5.18 (2.83)	1.35 (1.22)	3.82 (2.65)	0.88 (0.78)	3.41 (3.40)	0.27 (0.32)	62.65 (20.01)
Control	18	5.11 (2.08)	2.56 (2.45)	2.56 (1.79)	2.56 (2.45)	2.17 (1.89)	0.50 (0.38)	59.39 (19.95)
Total	50	5.18 (2.22)	1.78 (1.89)	3.40 (2.16)	1.36 (1.80)	2.94 (2.04)	0.32 (0.35)	58.78 (19.77)
Novice auditors								
Operating	13	5.54 (3.45)	2.38 (1.89)	3.15 (2.23)	1.23 (1.24)	2.46 (2.07)	0.34 (0.36)	61.92 (22.78)
Strategic	17	5.41 (2.53)	2.06 (1.75)	3.35 (1.87)	1.18 (1.01)	3.12 (1.65)	0.30 (0.27)	69.41 (13.21)
Control	17	4.71 (3.31)	1.18 (1.47)	3.53 (2.76)	0.82 (0.95)	3.12 (2.57)	0.24 (0.30)	57.76 (18.21)
Total	47	5.19 (3.05)	1.83 (1.74)	3.36 (2.28)	1.06 (1.05)	2.94 (2.11)	0.29 (0.31)	63.13 (18.36)

<sup>a</sup> Cue type is based on subjects' classifications of the cues.

Proportional Recall = proportion of positive cues divided by the sum of positive and negative cues recalled.

Going-concern judgment = probability that the company will continue on a scale from 0 to 100.

Strategic = experimental condition where participants received information with respect to client strategic turnaround initiatives

Operating = experimental condition where participants received information with respect to client operating turnaround initiatives

Control = experimental condition where participants received no information with respect to client turnaround initiatives

TABLE 5  
Effect of Turnaround Initiatives and Experience on Proportional Recall

<i>Panel A: Analysis of Variance-Path B</i>				
Source of Variation		df	F-statistic	P-value
Main Effects				
Experience		1	0.10	0.757
Initiatives		2	1.08	0.344
Interaction				
Experience*Initiatives		2	3.95	0.023**
<i>Panel B: Planned Comparisons-Path B</i>				
Contrast	Hypothesis	Effect Size	T-statistic	P-value <sup>a</sup>
Control vs. Operating	H3a	-0.11	-1.41	0.081*
Control vs. Strategic	H3b	0.08	1.04	0.151
Experienced:				
Control vs. Operating	H4a	-0.34	-2.99	0.002***
Control vs. Strategic	H4b	-0.23	-2.10	0.019**
Novice				
Control vs. Operating	H4a	0.11	0.90	0.184
Control vs. Strategic	H4b	0.07	0.61	0.271

<sup>a</sup> one-tailed

\*\*\*, \*\* indicate significance at the .10, .05 and .01 level, respectively.

Going-concern judgment = probability that the company will continue on a scale from 0 to 100.

Proportional Recall = proportion of positive cues divided by the sum of positive and negative cues recalled.

Initiatives = turnaround condition (Strategic, Operating, Control)

Experience = level of experience (Novice, Experienced)

Strategic = experimental condition where participants received information with respect to client strategic turnaround initiatives

Operating = experimental condition where participants received information with respect to client operating turnaround initiatives

Control = experimental condition where participants received no information with respect to client turnaround initiatives

TABLE 6  
Effect of Turnaround Initiatives, Experience and Proportional Recall on Going-Concern Judgment

*Panel A: Analysis of Variance-Path A and C*

Source of Variation	df	F-statistic	P-value
<b>Main Effects</b>			
Experience	1	1.72	0.193
Initiatives	2	2.39	0.097*
Proportional Recall	2	10.30	0.002***
<b>Interaction</b>			
Experience*Initiatives	2	0.05	0.952

*Panel B: Planned Comparisons-Path A*

Contrast	Hypothesis	Effect Size	T-statistic	P-value <sup>a</sup>
Control vs. Operating	H1a	-1.39	-0.30	0.383
Control vs. Strategic	H1b	-8.97	-2.05	0.022**
<b>Experienced:</b>				
Control vs. Operating	H2a	-0.65	-0.10	0.461
Control vs. Strategic	H2b	-7.58	-1.21	0.115
<b>Novice</b>				
Control vs. Operating	H2a	-2.13	-0.32	0.375
Control vs. Strategic	H2b	-10.37	-1.67	0.049**

<sup>a</sup> one-tailed

\*,\*\*,\*\*\* indicate significance at the .10, .05 and .01 level, respectively.

Proportional Recall = proportion of positive cues divided by the sum of positive and negative cues recalled.

Initiatives = turnaround condition (Strategic, Operating, Control)

Experience = level of experience (Novice, Experienced)

Strategic = experimental condition where participants received information with respect to client strategic turnaround initiatives

Operating = experimental condition where participants received information with respect to client operating turnaround initiatives

Control = experimental condition where participants received no information with respect to client turnaround initiatives

## APPENDIX 1: EXCERPTS FROM EXPERIMENTAL INSTRUMENT

### PANEL A: THE SECTION “CURRENT STRATEGIC INITIATIVES AND REALISATIONS” IN THE STRATEGIC CONDITION.

#### **Current strategic initiatives and realisations**

The Company recognizes that more immediate and measurable objectives are required in order to effectively carry out its long-term strategies. As a result, the Company's Board of Directors and senior management meet annually to review the strategic imperatives. These strategic imperatives, which generally span a three to five year time frame, target specific issues in response to changes in consumer needs and the competitive retail landscape.

Because 2005 was a quite challenging year for Indigo, the company engaged in 2005 in the implementation of several cooperative agreements in order to increase cash flow and to restore earnings and sales growth:

#### **Establishing strategic alliances**

A noticeable trend in the industry has been the movement to one-stop shopping, meaning that supermarkets expand the number of nonfood items that are offered (e.g., pharmacy, music, photo-finishing, dry cleaning, flowers, videos, books, printing, postal services, and travel services).

In order to enhance Indigo's one-stop shopping experience and expand its services, the company entered into strategic alliances in 2005 with a major restaurant chain, a photo-finishing company and a bakery.

Moreover, an alliance with a well known packaged food company is close to being signed. This alliance will expand the product line of ready-made meals with new high-quality, pre-prepared products.

In 2005, Indigo banking services were also introduced in some stores through PC Financial in collaboration with the Canadian Imperial Bank of Commerce, one of the largest banks in Canada. Based on detailed market studies conducted by a professional marketing firm, these actions are expected to increase revenues with 30 million in 2006.

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**PANEL B: THE SECTION “CURRENT STRATEGIC INITIATIVES AND REALISATIONS” IN THE OPERATING CONDITION.**

**Current strategic initiatives and realisations**

The Company recognizes that more immediate and measurable objectives are required in order to effectively carry out its long-term strategies. As a result, the Company’s Board of Directors and senior management meet annually to review the strategic imperatives. These strategic imperatives, which generally span a three to five year time frame, target specific issues in response to changes in consumer needs and the competitive retail landscape.

Because 2005 was a quite challenging year for Indigo, the company engaged in 2005 in the implementation of a cost-cutting plan to increase cash flow and to restore earnings and sales growth:

**Starting an extensive cost-cutting program**

In 2005, Indigo analyzed its expenses, resources and liquidity and took steps to mitigate the effects of this slowdown by substantially reducing quarterly operating expenses. More specifically, the company has started a multi-year action plan to reduce logistics and distribution costs per case substantially through a combination of leveraging volume growth and operation process changes. A key part of this initiative is to address supply chain costs by shipping from Indigo distribution centers to stores instead of directly from vendors to stores, which is expected to result in a cost saving of \$19 million in 2006. In addition, Indigo further expects to decrease expenses by an additional \$11 million by reducing use of third party service providers, reducing use of professional consultants, lowering salaried labor costs and decrease spending by the administrative department.

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