

Response by Professor David Citron to the Sharman Inquiry's Call for Evidence on Going Concern and Liquidity Risks

I was pleased to hear about the launch of this important inquiry and hope it will lead to improved reporting in the crucial area of going concern disclosure. I will restrict my response to the implications of two areas of research I have conducted together with colleagues. In both cases the regulatory environment has improved since the period covered by the research – but, in view of management's reluctance to disclose bad news, I believe it would be worthwhile to monitor whether the improved regulations have actually produced the hoped-for improvements on the ground. The findings relate primarily to your Question 3 concerning barriers to full going concern disclosure.

1. 'Management Going Concern Disclosures: Impact of Corporate Governance and Auditor Reputation' by Uang et al. (*European Financial Management*, Vol.12 No.5, 2006, pp.789-816).

This paper studied the quality of the management going concern disclosures of 179 UK firms that received audit going concern modifications between 1994 and 2000. The key finding was a surprising reluctance on the part of management to report truthfully on the existence of their going concern problems despite the facts being recorded elsewhere in the annual report. 18% of cases made no direct comment about their going concern problems and 31% made 'optimistic' disclosures. A second finding was that positive auditor characteristics (such as high reputation) and certain corporate governance mechanisms (such as relatively high institutional ownership) were associated with more appropriate management disclosures.

The 1994 Guidelines were in force during the period covered by this research. Paragraph 24 of the new Guidelines seems to make a stronger link between the nature of the audit report and that of the management disclosures, so I would expect to see an improvement in the quality of management disclosures. In view of our surprising findings summarised above, however, this is worth monitoring. The importance of auditor independence and of strong corporate governance mechanisms in encouraging better quality management disclosure should also be borne in mind.

2. 'Delays in Reporting Price-Sensitive Information: The Case of Going Concern' by Citron et al. (*Journal of Accounting and Public Policy*, Vol.27, 2008, pp.19-37).

The paper found that of 91 companies receiving audit going concern modifications between 1994 and 2000, as many as 58% failed to report the forthcoming modification in their preliminary announcements. However, this was at a time when listing requirements required such disclosures only in the case of forthcoming audit *qualifications*, not mere *modifications*. I note that

the listing requirements have since been significantly strengthened (as set out in para.77 of the new Guidelines) to require disclosure of forthcoming modifications. Once again I believe that it would be worthwhile to conduct research into the hoped-for improved disclosures of this price-sensitive information.