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Are Audit Opinion Modifications Associated with Future Financial Restatements?

Mohammad J. Abdolmohammadi* and **William J. Read**

Bentley College, Waltham, MA USA

We examine the frequency and type of audit opinion modifications (e.g., going concern, GAAP consistency) in a sample of 180 companies that restated their financial statements for the reporting periods 1998-2001 compared with a control sample matched on the basis of industry, size, reporting period, and audit firm. The literature suggests that restatement firms are less profitable and have higher financial distress than non-restatement firms, resulting in a greater likelihood of earnings management. Thus, we expect restatement firms, in periods immediately preceding restatement as well as the period of restatement, to receive more going-concern reports and audit opinions modified for lack of consistent application of accounting principles. We find that auditors modify their opinions for the restatement sample at a rate twice that of the control group for each of the three years immediately preceding restatement as well as the period of restatement. These findings suggest that certain audit opinion modifications (e.g., going concern, lack of consistency in application of accounting principles) might be relevant information to users of financial statements in assessing the possibility of future financial restatement.

INTRODUCTION

The literature suggests that restatement firms are more likely to be less profitable and be in weaker financial condition with financial distress. Thus, it would seem that restatement firms are more likely to have going-concern problems and to make more changes in generally accepted accounting principles (GAAP), given their incentives to manipulate earnings. Companies that restate financials to correct material errors or fraud also have been identified (see Kinney et al. 2004) with increased merger and acquisition activity. Hence, taken collectively, it would seem that certain characteristics of restatement firms make them more likely, in reporting periods preceding restatement as well as the period of restatement, to receive going-concern audit reports and audit opinions modified for lack of consistency or that reflect divided auditor responsibility attributable, for example, to a recently acquired subsidiary audited by another auditor.