



Management Turnaround Initiatives and Auditor's Going-Concern Judgment: Memory for Audit Evidence

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ABSTRACT

This study experimentally investigates how management turnaround initiatives influence auditor going-concern decisions involving a financially distressed firm. Prior archival going-concern research (e.g., Behn, Kaplan & 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 (Bruynseels & Willekens, 2008). We add to this research by examining the mechanisms through which 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, but no significant direct influence of operating turnaround initiatives. Our analyses of the *indirect* effects show that the implementation of both types of management turnaround initiatives leads to increased recall of negative financial cues, but only for experienced auditors. This further suggests that management initiatives, regardless of their nature, may have a negative indirect effect on going-concern judgments of experienced auditors.

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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 & Thomas, 1997; Lemon, Tatum & Turley, 2000; Bell, Peecher & Solomon, 2005; Knechel, Salterio & Ballou, 2007). 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 & Krumwiede, 2001; Geiger & Rama, 2003; and Bruynseels & Willekens, 2008). 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 consistent with prior studies which have documented that an auditor's evaluation of subsequent evidence is affected by the obtained holistic perspective through the assessment of a client's strategic performance. 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 & Watkins, 1988; Biggs, Selfridge & Krupka, 1993). This suggests that the direct effect of turnaround initiatives on going-concern judgment might be more pervasive for experienced 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). Our results show 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 also observed an *indirect* effect for experienced auditors who recalled more negative evidence cues when presented with information about either operating or strategic 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 for experienced auditors are particularly interesting because we find that both types of client initiatives result in the recall of more negative financial evidence but experienced auditors still rate the chance of survival significantly higher when a client undertakes a strategic initiative in spite of the focus on negative financial cues. This, indeed, suggests a very deep level of analysis among the experienced auditors.

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 & Trotman, 1991; Tan, 1995; Rau & Moser, 1999; Hoffman, Joe & 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 first investigate the overall effect of turnaround initiatives on going-concern judgment and consider the moderating effect of experience on auditors' consideration of client strategic and operating initiatives. In the second stage of the analysis, we decompose the overall effect into 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 argue that the strength of both the direct and 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 ISA 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 & Pearce, 1992), while other studies cast doubt on the likely success of operating approaches for coping with financial distress (Barker & Mone, 1994; Sudarsanam & 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 & 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_{1a}: 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. Prior research has documented that strategic initiatives are more likely to lead to successful 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.¹

H_{1b}: For financially distressed companies, the implementation of short-term strategic turnaround initiatives has a *positive* direct effect on an auditor's going-concern judgment.

¹ 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.

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 & Libby, 1986; Bonner, 1990; Bonner & Lewis, 1990; Libby & Frederick, 1990; Frederick, 1991; Choo & Trotman, 1991; Tubbs, 1992; Bédard & 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 judgment 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 also information that is atypical, such as mitigating going-concern evidence (Choo & 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 & Larter, 1983). In the same line of reasoning, Hoffman et al. (2003) argue that as repeated performance of the going-concern judgment leads to the routinization of certain aspects of the task (i.e. the

evaluation of financial information), more processing capacity will be free for performing the more cognitively demanding parts of the task (i.e. attending to and integrating nonfinancial mitigating information)². 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:

H₂: Client turnaround initiatives (operating or strategic) will have a greater direct effect on going-concern decision-making for experienced auditors than novices.

Path B: Effect of Turnaround Initiatives on Recall of Financial Evidence

There exists ample evidence that auditors' expectations and beliefs have a strong impact on their subsequent processing of consistent and inconsistent evidence (Ashton & Ashton, 1988; Tubbs & Messier, 1990; Bedard & Biggs, 1991; Church, 1991; Asare, 1992; McMillan & 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., 2007). 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 & McMillan, 1992). In general, an important attribute of schematic modeling is that individuals process information that is consistent with their

² A similar effect was found for benchmarking financial performance by Salterio, Knechel and Kotchetova (2006). Specifically, the presence of benchmarks facilitated more complete processing of the information in a set of performance measures for a client.

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, *ceteris paribus*, 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 & 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 & 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 the memorability of information is dependent on the extent to which it is mentally elaborated by the decision maker. Information inconsistent with expectations may be well remembered if the decision maker feels the need to make sense of the inconsistent information. In contrast, expectancy-congruent (consistent) information may be particularly well remembered if it supports the validity of initial expectations (Higgins & Bargh, 1987), and the decision maker is motivated to bolster the validity of these expectations (Srull & 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 in a company that is clearly

financially distressed. Previously discussed research suggests that management operating initiatives such as cost-cutting initiatives are not sufficient to trigger a company turnaround and may 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 & 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_{3a}: If a client implements short-term operating initiatives (as compared to no turnaround initiatives) auditors will recall more *negative* financial cues.

The case of strategic turnaround initiatives is more complex. On one hand, the mere fact that a client is financially distressed and needs to undertake efforts to turn the organization away from failure may create a negative impression in the auditor. However, 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 undertakes *strategic* initiatives. In either case, there is a potential conflict in the information signals the auditor receives concerning the company. The implications of the Associative Network Model (Srull & Wyer 1989) may be mixed in this situation. On the one hand, since a strategic initiative may be perceived as positive, an auditor might focus on expectancy-congruent information that is also positive (i.e., suggesting that the firm is likely to survive). On the other hand, since the strategic initiative is incongruent with the underlying financial condition of the firm, the auditor may focus on information that is expectancy congruent with the firm's condition (i.e., suggesting the

firm may fail). However, Srull and Wyer (1989) also suggest that a decision maker may feel the need to feel to make sense of information that is inconsistent with an auditor's general impressions, so expectancy-incongruent information may be well remembered regardless of whether the auditor starts with a positive or negative impression. This scenario is cognitively complex and given the inherent conflict between expectancy-congruent and incongruent information for competing decision frames, our next hypothesis is nondirectional:

H_{3b}: If a client implements short-term strategic initiatives (as compared no turnaround initiatives), auditors will recall more financial cues (either negative or positive).

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 an encountered problem 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 (Bouwman, Frishkoff & Frishkoff, 1987; Anderson, 1988). In contrast, novice decision-makers who lack these internal schemata are less likely to focus their attention on the information most relevant to the problem and will include more disjointed information items in their evaluation (Lehman & 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 & Mock, 1983, Bouwman, 1984). As a consequence, experienced auditors will recall more financial evidence indicative of potential going-concern problems, relative to novice auditors.

H₄: Experienced auditors will recall more negative financial evidence cues, relative to novice auditors, if a client implements (short-term strategic or operating) turnaround initiatives.

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 & Lynch 1988). 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:

H₅: Auditor recall of financial evidence will be *positively* associated with going-concern judgment.³

³ 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 & Trotman, 1991; Libby & Trotman, 1993; Tan, 1995; Phillips, 1999; Rau & Moser, 1999). We measure the proportion of recalled negative cues (i.e., the number of recalled negative 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 negative 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.⁴ 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

⁴ 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 & 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 negative cues as the proportion of negative cues recalled (i.e. the number of negative 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.⁵

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

⁵ 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.⁶ 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 2 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

⁶ 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.⁷ Experienced auditors spent less time than novices reading the general company information ($t = 3.07$, $p < 0.001$), the financial ratio information ($t = 3.54$, $p < 0.001$), the strategic information ($t = 2.68$, $p < 0.010$) and the financial information ($t = 5.27$, $p < 0.001$). 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 & Chi, 1993; Cuccia & McGill, 2000; Thibodeau, 2003). Further 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 use 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 judgment, and (3) after controlling for turnaround initiatives, the effect of turnaround initiatives on the going-concern judgment is reduced. In the case that the relationship between turnaround initiatives and going concern judgments is not significant after controlling for proportional recall, full mediation has occurred. 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

⁷ One exception is the reading of strategic information, which takes 0 seconds in the CONTROL condition.

mediation. In addition, we investigate the influence of experience on the nature of the direct and indirect judgment effects.

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 & Rama, 2003; and Bruynseels & Willekens, 2008). 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). The ANOVA results indicate no significant effect of turnaround initiatives on going-concern judgment ($F=1.87$, $p<0.159$) for the sample as a whole,

Since 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 for experienced and novice auditors separately. The results of the contrast analysis indicate 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 (2008), 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 & Rama, 2003). Conversely, we do not find evidence of any effect of

operating initiatives on going-concern judgment when compared to the control group ($t = -0.16$, $p < 0.436$, one-tailed). Further analysis 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 difference of 8.96% between the operating condition and the strategic condition (not tabulated) is significant ($t = -1.33$, $p < .093$, one-tailed).

<<<<< 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. 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.⁸ Experienced auditors also recalled more negative financial cues compared to novice auditors in the strategic and operating conditions. 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 their focus on evidence cues is more negative regardless of the nature of management's initiatives.

⁸ 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.

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

The impact of management initiatives on proportional recall of negative going-concern evidence is estimated using an ANOVA model with proportional recall as the dependent variable and experience and management initiatives as independent factors. The results of the ANOVA are presented in Table 5. Neither experience or management initiatives are significant as a main effect for proportional recall of financial evidence (Panel A) 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 test H_{3a} and H_{3b} without considering the interaction effect between management initiatives and experience. For novices, the proportional recall of negative financial cues in the control condition was not statistically different from the proportional recall in the operating or strategic conditions. However, for experienced auditors, proportional recall of negative financial information in the operating condition was significantly higher than the control condition ($p<.002$, one-tailed). Additionally, experienced auditors had higher proportional recall of negative financial information in the strategic condition relative to the control condition ($p<.019$, one-tailed). These results support both H_{3a} and H_{3b} but only for experienced auditors. Novice auditors do not have the ability to analyze the going concern issue at such a complex level. This further 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 H_4 .

<<<<< 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 variables, and the observed proportional recall as a co-variate. Mediation is indicated by a significant covariate; partial mediation through recall is identified if the variable reflecting management initiatives remains significant after controlling for proportional 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. Proportional recall of financial evidence is positive and significant ($F=11.30$, $p<.002$), which provides strong support for H_5 . Management initiatives remain marginally significant when we include experience and financial recall in the analysis ($p<.097$), suggesting that turnaround initiatives have a direct effect on auditors' going-concern judgment. We test hypothesis H_{1a} and H_{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 H_{1b} . 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 does not support H_{1a} . The interaction between experience and management initiatives is not significant, i.e., 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 ($t= 1.67$, $p<.049$). This result does not support H_2 .

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 direct and the indirect effect have offsetting signs (Mac Kinnon, Krull & Lockwood, 2000; Shrout & Bolger, 2002). In fact, the total effect may even be close to zero under such conditions. Because our results show opposite signs for the direct and indirect effect of strategic turnaround initiatives, the effect of mediation may explain the weak results obtained in Table 3 for the test of the overall effect of strategic initiatives on auditor judgment. That is, it is highly likely that the effect of strategic initiatives on going-concern judgment is empirically weak due to this suppression process caused by the opposite effects observed in testing H_{1a} and H_{1b} vis-à-vis H_{3a} and H_{3b} .

<<<<< 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 & Rama, 2003; Bruynseels & Willekens, 2008) indicate that actions taken by management, such as cost-cutting and strategic initiatives with a short-term impact, can 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 a slight positive overall effect on going-concern judgments, whereas operating initiatives do not have a significant influence on going-concern decisions. When decomposing this overall effect of management initiatives on going-concern judgment into a direct effect and an indirect effect through recall of financial evidence, we find a positive direct effect of short-term strategic initiatives on going-concern judgment, supporting H_{1b}. However, contrary to H_{1a}, we find 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 (contrary to H₂). With respect to the indirect effect of management initiatives on cue recall, we predicted that operating initiatives would lead to more recall of negative financial cues while strategic initiatives would lead to more recall of either positive or negative financial cues, and that the focus on negative financial information would be more pronounced for experienced auditors. Our analyses of the indirect effects show that the implementation of both types of management turnaround initiatives leads to increased recall of negative financial cues (consistent with H_{3a} and H_{3b}), but only for experienced auditors (supporting H₄). This can be explained by the fact that the 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 their 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. Finally, there was a strong positive association between evidence recall and the overall going concern judgment (consistent with H₅). 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 their relative lack 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 & Willekens, 2008), it would be interesting to analyze the impact of a variety of turnaround initiatives on going-concern decisions.

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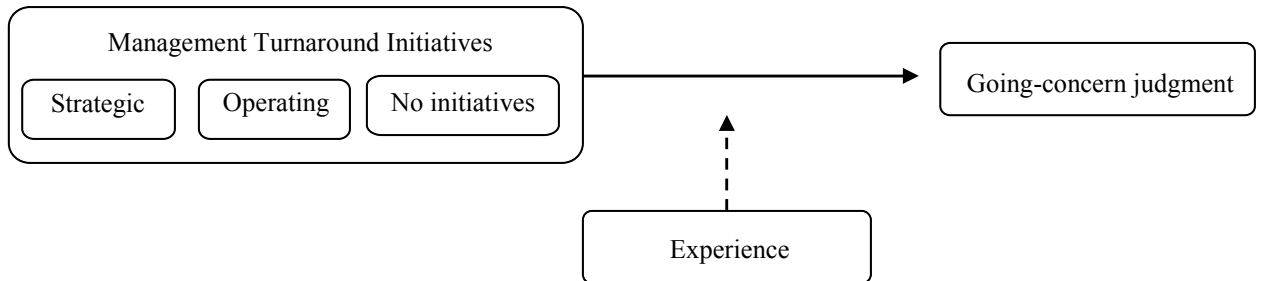
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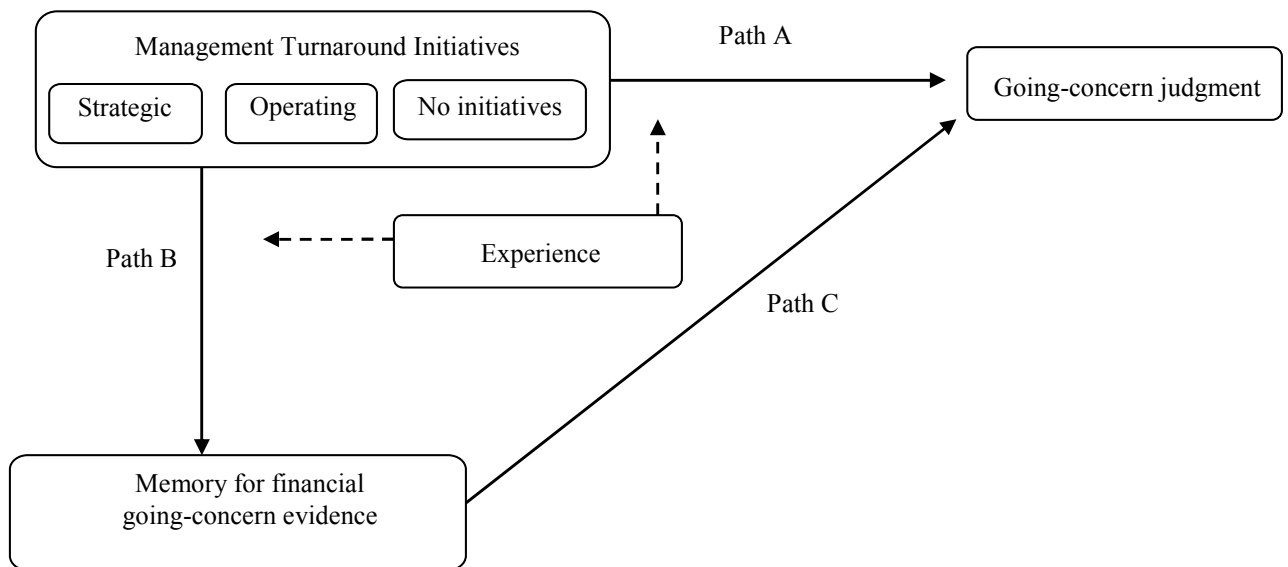
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FIGURE 1
 Relation between client turnaround initiatives, experience, memory for going-concern evidence and the going-concern opinion.

PANEL A: The total effect of client turnaround initiatives on going-concern judgment



PANEL B: Decomposition of the total effect of client turnaround initiatives into a direct effect and an indirect effect through memory for financial going-concern evidence



Direct effect = Path A
 Indirect effect = Path B, Path C

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"> • Business and history • Industry information • Vision and operating strategy 	<ul style="list-style-type: none"> • Business and history • Industry information • Vision and operating strategy 	<ul style="list-style-type: none"> • Business and history • Industry information • Vision and operating strategy
	<ul style="list-style-type: none"> • Financial ratios • Current strategic initiatives and realisations (strategic alliances) 	<ul style="list-style-type: none"> • Financial ratios • Current strategic initiatives and realisations (cost-cutting) 	<ul style="list-style-type: none"> • Financial ratios
	<ul style="list-style-type: none"> • Financial company information 	<ul style="list-style-type: none"> • Financial company information 	<ul style="list-style-type: none"> • Financial company information
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 for the subsample of experienced auditors

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 industry 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

Panel A: Analysis of Variance

Source of Variation	df	F-statistic	P-value
Main Effects			
Experience	1	1.32	0.253
Initiatives	2	1.87	0.159
Interaction			
Experience*Initiatives	2	0.65	0.526

Panel B: Comparisons of Going-Concern Judgments

Contrast	Effect size	T-statistic	P-value ^a
Operating <i>minus</i> Control	-0.78	-0.16	0.436
Strategic <i>minus</i> Control	7.45	1.63	0.053*
Experienced:			
Operating <i>minus</i> Control	-5.72	-0.86	0.196
Strategic <i>minus</i> Control	3.26	0.51	0.307
Novice			
Operating <i>minus</i> Control	4.16	0.59	0.277
Strategic <i>minus</i> Control	11.65	1.79	0.039**

^aone-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 ^a	Negative Cues ^a	Positive Financial Cues ^a	Negative Financial Cues ^a	Proportional recall ^b	Going-Concern Judgments ^c
Experienced auditors								
Operating	15	5.27 (1.67)	1.33 (1.50)	3.93 (1.71)	0.47 (0.64)	3.33 (1.59)	0.83 (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)	0.73 (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)	0.68 (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)	0.66 (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)	0.70 (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)	0.76 (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)	0.71 (0.31)	63.13 (18.36)

^a Cue type is based on subjects' classifications of the cues.

Proportional Recall = proportion of negative 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

Panel A: Analysis of Variance-Path B

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**

Panel B: Planned Comparisons-Path B

Contrast	Hypothesis	Effect Size	T-statistic	P-value ^a
Operating <i>minus</i> Control	H3a	0.11	1.41	0.081*
Strategic <i>minus</i> Control	H3b	0.08	1.04	0.151
Experienced:				
Operating <i>minus</i> Control	H4	0.34	2.99	0.002***
Strategic <i>minus</i> Control	H4	0.23	2.10	0.019**
Novice				
Operating <i>minus</i> Control	H4	-0.11	-0.90	0.184
Strategic <i>minus</i> Control	H4	-0.07	-0.61	0.271

^a 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 negative 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	Hypothesis	df	F-statistic	P-value
Main Effects				
Experience		1	1.72	0.193
Initiatives		2	2.39	0.097*
Proportional Recall	H5	2	10.30	0.002***
Interaction				
Experience*Initiatives		2	0.05	0.952

Panel B: Planned Comparisons-Path A

Contrast	Hypothesis	Effect Size	T-statistic	P-value ^a
Operating <i>minus</i> Control	H1a	1.39	0.30	0.383
Strategic <i>minus</i> Control	H1b	8.97	2.05	0.022**
Experienced:				
Operating <i>minus</i> Control	H2	0.65	0.10	0.461
Strategic <i>minus</i> Control	H2	7.58	1.21	0.115
Novice				
Operating <i>minus</i> Control	H2	2.13	0.32	0.375
Strategic <i>minus</i> Control	H2	10.37	1.67	0.049**

^a one-tailed

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

Proportional Recall = proportion of negative 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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