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Do key audit matters signal corporate bankruptcy?

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Abstract

Research Question: This paper aims to answer whether the Key Audit Matters (KAMs) Signaling Corporate Bankruptcy and investigate auditor responsibility versus the lack of auditing standards, and examine whether the disclosure of the KAMs by independent auditors enhances the prediction of corporate bankruptcy and the extent to which the KAMs reduce the information asymmetry between firm managers and shareholders.

Motivation: We analyse the risk topics in the annual reports, then the KAMs highlighted by the auditor and then the KAMs are disclosed by adopting a case study approach.

Data: We use a single descriptive case study approach and read the relative academic and professional literature to explore the KAMs included in the auditors' reports before the Thomas Cook Group Plc bankruptcy.

Findings: We find no significant predicting power of KAMs disclosed by Ernst & Young (EY) on Thomas Cook's annual reports. We found that the auditor is not responsible for indicating financial failure.

Contribution: We suggest that the regulators and the accounting boards adopt more restrictive standards and improve the International Standards on Auditing (ISA) 701. Furthermore, attention should be focused on the reliability of KAMs specified in ISA 701. We conclude that the KAMs are ineffective in disclosing bankruptcy risk. Our paper concludes that the current auditing standards should be more instructive in preventing corporate bankruptcy. We contribute to the literature in a unique and core research area not researched previously.

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1. Introduction

Corporate financial crisis forecasts are a critical discussion as the economic consequences of such crises are profound. Firm bankruptcy inevitably risks stakeholders, such as banks, creditors, managers, and investors. Even worse, some key corporate bankruptcies might negatively affect employability and economic growth. The ability to detect firm's bankruptcy risk is a vital topic for the stakeholders (Korol, 2019). According to United Kingdom Bankruptcies data from Trading Economics14F, there is an increasing trend in corporate bankruptcy frequency within the UK. Bankruptcy prediction is an interesting research area. According to ISA 700 and ISA 701, the independent auditor must disclose as much detail as possible on risk disclosure in the Key Audit Matters section (KAMs). However, bankruptcy risk is still not highlighted in the new audit report.

Auditors play an essential role for the stakeholders. Accountants construct the financial reports, but the auditors add credibility to them. Auditors perform the role of creating a level of confidence in the annual reports. Auditors test the validity of the financial information provided by the management. Therefore, they are the judges who assess the firm's financial health. According to agency theory, firm managers are agents, while auditors act on behalf of stakeholders (the principal) to audit and validate management's work and reassure the stakeholders regarding the trust and confidence they can have in the firm (Elmarzouky *et al.*, 2022; Pentland, 1993).

The independent audit report should warn the stakeholders and play an essential role in predicting corporate bankruptcy (Muñoz-Izquierdo *et al.*, 2020). Previous literature investigates the role of the independent auditor in signalling financial failure, and they link the ability to predict corporate bankruptcy to the independent auditor characteristics while measuring the audit quality using the independent auditor's educational background (Elmarzouky *et al.*, 2022; Ruiz-Barbadillo *et al.*, 2004; Cenciarelli *et al.*, 2018). The main focus in the previous literature was on auditor characteristics. Simultaneously, they measure the financial failure using Altman's traditional Z-Score model (Muñoz-Izquierdo *et al.*, 2020) or using financial ratios (Muñoz-Izquierdo *et al.*, 2019). The third group from the literature, such as (Caserio *et al.*, 2014) assessed the audit reliability for predicting corporate bankruptcy and used the going concern paragraph as an indicator for corporate bankruptcy.

To the best of our knowledge, there is no previous literature linking the audit risk narrative disclosure with the firm narrative risk disclosure. Our main focus here is to assess the ability of the KAMs to deliver a signal for financial distress when the stakeholders read the narrative section of the audit report that relates to risk (KAMs). Furthermore, auditors are required to test the firms' going concern statement (Desai *et al.*, 2020). As Thomas Cook Group Plc had been audited by one of the Big Four accounting firms for many years, the auditors should have complied with the audit report regulations. Therefore, this allows researchers to draw conclusions about the usefulness of the KAMs and make recommendations for possible improvements.

The paper aims to analyse whether KAMs effectively predict corporate bankruptcy. We investigate the risk topic actually in the annual reports, the risk topics highlighted by the auditor (KAMs), and the risk topic that would have been disclosed. More specifically, we discuss the KAMs in the Thomas Cook Group Plc audit reports, which were compiled following the regulations and the KAMs that would have been reported before its insolvency. The annual reports were collected from the firm's website, and the KAMs are analysed in detail for the years 2017 and 2018, together with the interim report for 2019. We further investigate how the KAMs are applied and why the KAMs failed to predict the Thomas Cook bankruptcy. To the best of our knowledge, no case studies have been done to date to assess the KAMs and their power to predict bankruptcy. Thus, the case study fills this gap by attempting to develop a theoretical explanation for any unexplored practice (Lantto, 2014). Therefore, we incorporated the KAMs in a case study, which investigates whether the KAMs are able to predict corporate bankruptcy and their application regarding accounting policies effectively. The paper sheds light on the current auditing standards and suggests a framework for the KAMs.

The remaining parts of the paper are organised as follows. Section 2 briefly provides background information on Thomas Cook and KAMs, and Section 3 presents the research methodology. The case study of KAMs and their application regarding predicting the bankruptcy of Thomas Cook are presented in Section 4. Finally, section 5 concludes with limitations and recommendations for future research.

2. Literature review and hypotheses development

On 15th December 2016, ISA 701 came into force in the UK, which changed the independent auditor's focus to a risk-based audit approach. The ISA 701 communicating KAMs is a new concept in the audit process. According to ISA 701, the auditors need to identify and disclose any matter that is risk-related in their professional opinion. There is an increasing amount of literature investigating the usefulness of these changes. Sago (2018) found that the KAMs create new knowledge, and it is useful to the stakeholders by conducting a survey to assess the perceptions of the professional and non-professional stakeholders in Thailand. He also did a content analysis of the extended audit report, which showed that the stakeholders realised its usefulness. However, to the best of our knowledge, no research linked the KAMs and corporate bankruptcy due to the newness of adopting the KAMs.

More research needs to be done to assess the credibility of audit reports (DeFond & Zhang, 2014; Geige *et al.*, 2019). The consequences of adopting ISA700 have been investigated by many researchers. Gutierrez *et al.* (2018) assessed the extended audit report's indirect effect on investor reactions, audit fees, and audit quality and found the relationship to be insignificant. This means that the extended audit report failed to provide sufficient information to the stakeholders. This study aligns with Segal (2019) that argues that the new audit report does not add much additional information for the investors. We aim to assess these findings in a case study. Nevertheless, no research considers the KAMs in the context of corporate financial failure.

Iwanowicz (2019) found that the adoption of the materiality section and the KAMs section in audit reports decreased the audit expectation gap. However, it is not clear how the new audit report provides a warning message to the stakeholders regarding corporate bankruptcy. Another research conducted by Li (2018) investigated the association between the extended audit report's existence and audit quality. However, he did not provide any evidence that links the audit quality with the financial reporting, especially in the bankruptcy case. Zhang and Ofori-Mensah (2019) provided evidence that adopting the new audit report would increase the independence of the auditors, but this does not necessarily mean that the KAMs will be in the interest of the stakeholders when it comes to going concern issues. The link between the KAMs and corporate bankruptcy is yet to be researched due to the newness of the adoption of KAMs. We have a unique contribution to add to the literature on audit reporting and corporate failure. The KAMs are the risk topics that the auditor, in his professional judgment, decided to investigate more and share with the stakeholders (Iwanowicz, 2019). Bankruptcy is a significant risk that needs to be disclosed by the auditor. How the auditor discusses the bankruptcy in the KAMs and to what extent remain a question. Incorporating KAMs in a case study to thoroughly investigate whether the KAMs can effectively predict corporate bankruptcy is the main contribution of this study.

2.1 Background of Thomas Cook

Thomas Cook - "Do not just book it, Thomas Cook it!"
The founder of the business was Thomas Cook, a British businessman. He was the innovator of the conducted tour and founder of Thomas Cook and Son, a worldwide travel agency. Cook can be said to have invented modern tourism, and they opened a general store which was engaged in the business of providing travel services to customers. In 1850, Thomas Cook was considered the most important travel agency

in the UK. The firm was popular for travel packages where the firm would book flights, hotels and tours on behalf of the customers (Thomas Cook Group, 2018). Thomas Cook Group and all UK entities went into compulsory liquidation, and the Thomas Cook Group ceased trading on 23rd September 2019. On 26th December 2019, it was announced that Thomas Cook Balearics had closed down after becoming insolvent. Approximately 21,000 employees worldwide were left without jobs (including 9,000 UK staff), and 600,000 customers (150,000 from the UK) were stranded abroad, triggering the UK's most massive peacetime repatriation. The bankruptcy of Thomas Cook directly affected all the existing EU financial instruments (Soone, 2019). Even worse, taxpayers face up to a £60m bill over Thomas Cook's collapse to refund its 9,500 former staff's unpaid wages, holiday pay, and redundancy costs.

Thomas Cook was audited by one of the Big Four firms. EY took over from PwC (PricewaterhouseCoopers) as Thomas Cook's auditors in 2017. Both are among the UK's Big Four accountancy firms. Interestingly, EY had previously been fined $10 000 US dollars with regard to a similar bankrupt situation (Chatterjee, 2015). As Eric Schneiderman, attorney-general of New York state, stated, "If auditors issue opinions that are unreliable or provide cover for their clients by helping to hide material information, that harms the investing public, our economy, and our country." Therefore, auditors play an essential role in monitoring corporate risks to prevent a bankruptcy crisis.

2.2 The collapse of Thomas Cook's impact on the tourism industry around the globe

The oldest tour operator in the world was famous for its package holidays to more than 60 destinations. Spain was the company's main destination. In one year, more than 1.3 million passengers have travelled to Spain on Thomas Cook Airlines. That does not include a further 1.6 million passengers who travelled on Condor Airlines, in which Thomas Cook has a 49% stake. The tourism sector in Spain's Balearic Islands faces millions of euros in losses. Thomas Cook has a tax office in Palma with hundreds of employees and also works with 20 hotels in the Balearic Islands and 20 in the Canary Islands. Turkey's Hoteliers Federation (TUROFED) has warned that the country could miss out on up to 700,000 tourists a year due to the collapse of the tour operator. According to official data, about 40 million tourists travelled to Turkey in 2018, bringing in $29.5 billion (£23.8 billion). The chairman of TUROFED, Osman Ayik, told Reuters: "There are a large number of small businesses whose fates depend on Thomas Cook, especially in Mugla, Dalaman and Fethiye." Small hotels in Turkey are still owed around £100,000 – £200,000 ($125,000-$250,000). About 250,000 people travel annually to Cyprus with Thomas Cook, bringing an estimated €18.5 million (£16.3m, $20m), according to Cyprus' deputy tourism minister. The wider economic loss in Cyprus is about €50 million. Goa, a winter holiday destination, was reliant on Thomas Cook charter flights which brought in about 2,000 tourists a week from October to March. Thomas Cook has been operating for the last 25-30 years in Goa, and losing out on Thomas Cook is a big, big blow to the industry." (Jones, 2019).

3. Research methodology

The corporate scandal became popular in the UK. Big names in the UK market went into a demonstration, such as Edinburgh Woollen Mill (EWM Group), Clarion, Mothercare, Pound world, and Thomas Cook. We apply our research on Thomas Cook for many reasons. Thomas Cook is well-established nationally and internationally. The 178-year-old firm provides multiple services and products, such as travel agencies, holidaymakers, tourism services and flights. Thomas Cook failed suddenly, and the firm declared bankruptcy on 23rd September 2019. We are interested in exploring how the KAMs were presented in the audit report for Thomas Cook. This is to assess whether the KAMs achieved the target of delivering sufficient information on the interest of the stakeholders and warning them prior to the collapse.

A descriptive case study is usually designed to describe an accounting practice (Korol, 2019). This paper focuses on corporate bankruptcy risk prediction within the KAMs disclosed by the auditor by adopting such an approach. It further investigates the collapse of Thomas Cook in detail. Thomas Cook's collapse led to the emergence and immediate application of the Auditing Standard 701 on communicating KAMs in the independent audit report. Therefore, the paper aims to investigate Thomas Cook's collapse and its applications to the new KAMs regulations (ISA 701). Also, the failure to highlight KAMs by independent auditors while giving their opinion on the financial statements will be discussed. As the financial reports' reliability is important (Bhasin, 2016), the paper will suggest how the ISA 701 should be implemented and how the KAMs should be mentioned in audit reports.

We use content analyses to investigate Tomas Cook's annual reports for the fiscal year 2017 and fiscal year 2018 and the interim report for 2019. We analyse the financial statements, the chairman statements, the audit committee reports, and the independent audit reports. We focus on the risk disclosed by the management and the risk topics disclosed by the auditors (KAMs). To explore how the KAMs were presented in the audit reports for Thomas Cook, the research started to investigate Thomas Cook with the proposed KAMs in 2017 when ISA 701 came into force in the UK. To benefit from our case study, we rely on the most recent annual reports for the last two fiscal years prior to the collapse (Seltzer, 1997); we use data from the firm's annual reports of 2017, 2018 and the interim report for 2019, which is also consistent with Min and Kee (2019).

The case study is an important type of research in auditing research as it makes it more relevant and applicable. A descriptive and explanatory case study provides an understanding of accounting practice (Kakkuri-Knuuttila *et al.*, 2008) and highlights any failure in this practice (Scapens, 1990). The lack of understanding of the case study approach creates concern over its contribution (Wickramasinghe & Hopper, 2005). A case study deals with unusual circumstances and explores a phenomenon in depth (Rashid *et al.*, 2019). Previous researchers have designed the case study in auditing to explain the way the audit report has been produced and to offer a proposed audit report or a simulation of how the audit report should be done (Cooper & Morgan, 2008).

Case studies consider an innovative approach which is not usually backed by a strong theory or a theoretical background (Otley & Berry, 1994). The research, in general, is to test or build a theory, while the case study is meant to study a case (Willis, 2014). The case study approach can be used to present results of how useful the audit report is (Bahati, 2015) but is not used to analyse a situation in detail as the single case study is considered storytelling (Gustafsson, 2017). The single case study is unique and ideal for observing an accounting practice (Lamberton, 2000), and it is primarily used to explore and investigate practice (Scapens, 1990). Investigating a real-life scenario is the main contribution of case studies (Ridder, 2017).

Using a case study approach also helps to build a theory from the case used (Lee *et al.*, 2007). A case study is a useful tool for building a logical argument which can lead to the replacement of a theory and should be based on observations without being limited or restricted by a theory (Merino & Neimark, 1982). Other researchers found that the case study based on philosophical arguments and assumptions without theory is accepted practice in published research papers (Ridder, 2017).

The audit report is the most credible and reliable source of information for the stakeholders, especially the KAMs (Min & Kee, 2019). Therefore, the content of the audit report, including the KAMs, is a vital source of information for the stakeholders. As a result, the independent audit report reduces the information asymmetry and the agency cost between the management and the stakeholders.

According to economic theory, there is an association between human behaviour (auditor) and the social setting (the stakeholders) (Scapens, 1990). A single case study may not start with a theory, and there is no assumed association between two variables – it simply understands a current issue (Ridder, 2017). There is a lack of empirical research on the adoption of ISA 701 on a single firm level. This case study, therefore, provides a detailed descriptive analysis and explores the adoption of ISA 701 at a firm level. The paper analyses further whether KAMs specified by ISA 701 effectively predict corporate bankruptcy.

Our aim is to assess the benefit of ISA 701 (KAMs) and whether it is achieved the target of providing sufficient information to the stakeholders in a timely manner. This is to find out if the auditor is to blame in case of corporate bankruptcy or if there is a drawback in the auditing standards. To achieve this aim, we will investigate the risk disclosure practice by the management and by the auditor and how would these risk matters would have been disclosed.

4. Discussion

4.1 Risk topics in the annual reports - Why did Thomas Cook collapse?

In this section, we first review the process of Thomas Cook's bankruptcy and summaries the potential reasons for its insolvency in 4.1. Then Audit Committee reports and Risk Committee reports of the years 2017 and 2018 for Thomas Cook are explored in 4.2, followed by a detailed analysis of KAMs the auditor disclosed and could have disclosed in 4.3 and 4.4, respectively. In 4.3, we further discuss whether it is the auditor's responsibility to predict bankruptcy risk or just to follow the accounting standards.

4.2 The collapse of Thomas Cook

Reviewing a five-hour debate of selected committees by the UK Parliament16F with Thomas Cook Group Plc board of directors and EY firm reveals some facts about the collapse of Thomas Cook Group Plc. Peter Fankhauser, Chief Executive for five years and former CEO of Thomas Cook, was appointed in 2014. He claimed that the main reason for the collapse was the interest and refinancing cost, which was £1.2bn in 2012. The former CEO believed that if half of this debt cost had been reinvested, the outcome would have been different. Although accused of paying £20m bonuses for the board members for the previous five years, the former CEO defended this by collecting a third of the bonus in shares that had not been sold, and there were no bonuses paid in 2018 and 2019. A clawback provision would be useless in this case17F.

Sten Daugaard and Warren Tucker, Board members, claimed that the firm had no positive cash generation because of the excessive borrowing. The high debt and high debt service costs, which were outside of the firm's control, appeared to be the main reason for the collapse.

Martine Verlyrn, Audit Committee director, stated that Thomas Cook flights were flying at 60% capacity, and the firm had not been prepared for that. Rachel Reeves, the speaker, asked why £2.5bn then remained as goodwill on the balance sheet. The management mentioned that the goodwill was based on the assumption of a 28% increase in earnings in the following year. However, the reality is that the firm had to write this goodwill down six months later. The former CEO explained that the assumption of a 28% earnings increase was built, considering the upside and downside scenario, but Thomas Cook experienced a terrible summer. Overstating the goodwill may have contributed to the loss of faith.

Frank Meysman, the former chairman, agreed that the problems were the high debt and the goodwill. The firm had £1.2bn debt at the time of the collapse. The question of why £ 800m wrote off the goodwill in May 2019 could not be explained. It was difficult to understand why this goodwill had not been written off before May 2019 and how the firm could justify goodwill of £2.5bn in the 2018 financial statements when the firm had huge debts. Also, this overestimated goodwill had remained on the balance sheet for many years. The former chairman and the former Chief Financial Officer added that the debt management had been well managed until May 2018, when uncertainty about Brexit was accompanied by a heatwave.

It is essential to highlight that the auditors who decided to write down the goodwill. The former CFO mentioned that the goodwill was not based on profit but on a new business plan. Thomas Cook was planning to adopt a new business model to compete with the current technology, and it was hard to switch the business model more quickly than that. Bear in mind that 40% of UK travellers booked their vacations online in 2018 (this was 20% in 2017). The goodwill was not estimated on the value of brands or customer loyalty, or skilled workers. So in May 2018, this goodwill could not be maintained anymore. In the previous eight years, Thomas Cook had a positive profit only once (£61m in 2015). So having this high goodwill was problematic

The speaker questioned the management for the exceptional items (non-occurring expenses). The firm had had £1.8bn in exceptional disclosed items for the previous eight years. These items were separately disclosed and considered as expenses that were not related to the ongoing business. The management argued that these exceptional disclosed items improved the share price (it was £0.25 in 2013 and £1.25 in 2014), which dropped back after 2018. These items increased the underlying profit and may have affected an accurate evaluation of profitability. Without these exceptional expenses, the figures were a lot worse. So the bonuses were indeed paid based on assumed profit (not the actual profit). The bonus system of Thomas Cook was based on cash flow generation, employee satisfaction, customer satisfaction and underlining operating profit. So £4m was paid in bonuses for Thomas Cook management with no allowance for these in the exceptional disclosed items. The board of directors was rewarded for failure. In 2019, the sale of the airline (the only profitable section of Thomas Cook) was delayed without an explanation.

The firm was using an out-of-date business model. Solvency Service sold Thomas Cook to Hayes within three weeks while the management had failed to do it for five years. The management also underestimated the cash needed to rescue the business as they first asked the banks for £700m, but they needed another £500m later. A total of £1.2bn was supposed to be injected to cover the loss, but in the absence of actual cover, this plan had been declined. The suppliers had tightened their payment conditions, and Thomas Cook failed to create competition tension. Despite the management trying to recapitalise the firm, transferring the bonds into shares (converting debt to equity), and a daily four o'clock valuation, the firm could not survive this crisis.

The 178-year-old firm failed after being faced with increased market competition, poor management decisions, and the massive uncertainty from Brexit, which led to the firm declaring bankruptcy on the 23rd of September 2019. The reasons that forced Thomas Cook Group Plc into liquidation are summarised as follows:

- A disastrous merger: Thomas Cook Group Plc merged with MyTravel (a UK-based travel agency) in 2007, which ended as a disaster. Thomas Cook went into massive debt and reported a loss of £1.5 billion in May 2017, with more than £1bn written off from the 2007 merger with MyTravel (Thomas Cook, 2019a).
- The new competition: The market had recently seen the entry of many low-cost travel and holiday firms such as Jet2Holidays, which caused more pressure on Thomas Cook Group Plc, issuing two profit warnings within two months. In addition, the market was shared by an Anglo-German multi-national travel and tourism company (TUI) (Thomas Cook, 2019b).
- Brexit: As the most common cause of uncertainty within the UK business, the Brexit deadline was 29th March 201919F. The UK public was frustrated, and the uncertainty delayed people's decisions about booking a holiday. People were more concerned about free movement and visa regulations, travel insurance validations, and flight taxes and charges, which created chaos for Thomas Cook Group Plc (Thomas Cook, 2019b).
- The technology: For the last decade, there has been an increasing number of internet-based holiday service providers. Thomas Cook Group Plc struggled to survive in the internet age, and the firm became less necessary to the public. A virtual business cuts the cost of doing business by not having physical offices, basing the headquarters in a low-tax area, and bypassing the tax laws using a loophole. Also, the internet-based business model helped customers to share information and reviews with one another at the push of a button. The availability of massive amounts of online information reduces the attraction of going to an office to get the same information. The traditional business model struggled to compete with modern ones such as Airbnb20F.

4.3 Risk committee reports and audit committee reports

Before we proceed to investigate KAMs and their application to bankruptcy prediction, we now consider the key risk matters in Risk Committee reports and

Audit Committee reports first. We here try to analyse whether these risk matters could be selected as KAMs to be disclosed in the independent audit report. We provide additional information from the risk committee reports and audit committee reports to understand the risk for the same period.

The principal risks for the financial years (FYs) 2017 and 2018 are summarised in Table 1. For FY 2017, there was only one category, Brexit, which had an increased risk exposure compared to 2016. Seven out of the total 13 risk categories were considered as the same level of risk in the year 2016. The remaining five risk categories showed a decreased risk trend.

Table 1: the principal risks of thomas cook based on the audit committee

Principal risks	**Financial year**	
	2018	2017
Strategic initiatives	⇩	⇩
Customer satisfaction	⬄	⇩
Quality of our products and	⬄	⬄
Digital strategy	⬄	⬄
Talent	⬄	⬄
IT Infrastructure	⬄	⬄
Cyber security	⇩	⇩
Disruption to airline	⇧	⬄
Cash and working capital	⇧	⇩
Health and Safety	⬄	⇩
Geopolitical uncertainties	⇩	⬄
Brexit	⇧	⇧
Compliance with regulatory	⬄	⬄

Note: ⇧ indicates **Increased risk**, ⬄ **Risk exposure unchanged**, and ⇩ **Reduced risk**.
Source: Thomas Cook, 2017, 2018

However, in FY 2018, three categories, namely disruption to airline operations, cash and working capital, and Brexit, experienced an increased risk exposure. More specifically, operational performance might be affected by economic, financial, regulatory, and market factors, many of which are outside management's control.

The Audit Committee was chaired by Martine Verluyten with members Dawn Airey (until 30th September 2017, Paul Edgecliffe-Johnson (from 21st September 2017), Lesley Knox, Jürgen Schreiber (from 21st September 2017), and Warren Tucker (Thomas Cook, 2017). Both top-down and bottom-up risk analyses had been reviewed by the Audit Committee and were considered appropriate. For FYs 2017 and 2018, the Audit Committee considered and addressed significant issues, including revenue recognition, maintenance of leased aircraft, provision for illness claims, goodwill and deferred tax, and going concerns. Most of the issues raised were selected as KAMs in the independent audit report, which is discussed in detail in the following subsection.

In the following sections, we will compare the KAMs disclosed with the proposed KAMs to understand the auditor's responsibilities better.

4.4 Risk topics highlighted by the auditor - KAMs that the auditor disclosed

Thomas Cook Group Plc was audited by EY (Ernst & Young), who took over from PwC (PricewaterhouseCoopers) as Thomas Cook's auditor in 2017. Both auditors are among the UK's Big Four accountancy firms. EY approved Thomas Cook Group Plc's annual reports and agreed that the financial statements had met the accounting standards; however, the audit report should have highlighted the going concern and shed light on the firm's increasing liabilities (Min & Kee, 2019). The firm's board of directors did not mention or discuss it enough on their financial statements.

The KAMs for both FYs 2017 and 2018 were unmodified, almost all of which were selected from the Audit Committee reports. EY, the independent auditor, approved the management financial statements. The auditors discussed the risk topics in the KAMs sections as follows:

For the year-end 30th September 2017:

- Revenue recognition: Due to manual recording in the underlying ledgers or via consolidation, EY suspected a management override, but they concluded that there was no materiality based on the auditor checks, and the change in the accounting application policy was not material to the financial statement as well.
- Leased aircraft maintenance: Despite the complex calculation and forecast for the maintenance of the aircraft, EY confirmed that the forecast assumptions were appropriate and supported by underlying evidence with a minor correction to the risk-free rate adjusted for credit risk.
- Provisions for illness claims: Although there were not enough supporting documents from the claimants, EY approved that the high level of illness claims was generally not material to the financial statements.
- Separately disclosed items: EY recommended that management focuses on the classification's nature, but they confirmed that the amount that remained unadjusted was not material.
- Goodwill: EY confirmed it was reasonable not to impair any goodwill for the year, although only the goodwill for the airline was defensible.
- Deferred Tax: EY recognised the deferred tax, and the differences between the tax regime in Spain resulted in a more extended recovery period due to the supporting taxable profit forecasts.

EY had nothing to report regarding principal risks facing the entity and concluded it was appropriate to adopt the going concern basis in preparing the financial statement in 2017. More specifically, there was no material inconsistency of going concerned in terms of the listing rules.

For the year-end 30th September 2018:

- Separately disclosed items: EY challenged management on the separately disclosed items and requested some adjustments be made to follow the group's accounting policy. The separately disclosed items were communicated to the Audit Committee. Although EY recommended strengthening the process of identifying the separately disclosed items, there was still a significant level of subjective judgment in determining these items.
- Going concerned: The basis of going concerned depends on Thomas Cook Group's continued access to capital, trading performance, and successful liquidity management concerning its financial covenants. EY put much effort into assessing whether the estimation of management's sensitive items and covenant headroom was appropriate. Having assessed the severity of the scenarios identified by management, EY confirmed that the assessment was reasonable and no significant uncertainty had been identified. EY concluded that using the going concern basis of accounting was appropriate.
- Revenue recognition: Some manual recording existed in the underlying ledgers or via consolidation. EY did not identify evidence of material misstatements in the revenue recognition and considered it appropriate.
- Leased aircraft maintenance: Despite the complex calculation and forecast for the aircraft maintenance, EY assessed this risk and confirmed that the assumptions within the model used to forecast these maintenances were appropriate.
- Provisions of illness claims: Management made adjustments to ensure good recoveries from suppliers. EY concluded there was no material misstatement, and the underlying calculations were assessed as reasonable.
- Goodwill: EY agreed with the management that there was no need for goodwill impairment, and they considered the disclosure of the sensitivity for the goodwill appropriate.
- Deferred Tax: The deferred tax was reasonable, and the basis of the recognition was due to supporting taxable profit forecasts as appropriate.

4.5 KAMs that the auditor should have disclosed

The disclosure regulations are ethically oriented (Merino & Neimark, 1982). Risk disclosure is expected to be useful to the stakeholders. So, if the KAMs did not effectively communicate information predicting corporate bankruptcy to Thomas Cook Group Plc stakeholders, then the ethics and morality behind the regulations are questionable. The auditor may or may not decide to discuss and share the observation with the stakeholders. However, there is no blame on the auditing firm under the current regulations. In terms of the regulations, the auditor must disclose but not influence management performance.

- The Financial Reporting Council (FRC) expressed concern over Thomas Cook Group Plc auditor, EY. They pointed to the independent audit report for 201821F. The FRC mentioned that the auditing behaviour of EY over the Thomas Cook 2018 financial year was still under investigation (Jones, 2019). According to ISA 701, auditors are required to disclose the KAMs, the matters that are of most significance in the audit of the financial statements, with professional judgement. If the audit standards had enforced the auditor to disclose all related risks (such as material misstatements, fundamental operational risks, and macroeconomic risks), the bankruptcy of Thomas Cook Group Plc, a 178-year firm, would not have happened, and the UK taxpayers would not have picked up the high costs, the firm would have been saved, and 9,000 jobs and 150,000 people stranded abroad could have been saved. Only if the ISA 701 was more detailed and enforced the auditor to disclose any concern observed as mandatory will we argue that EY, an example of the independent auditor, and after reviewing the last two years' financial statements, disclose the following: items in addition to the current KAMs.
- Interest and refinancing cost: The refinance and debt cost had been an alarming amount of £1.2bn since 2012, and the firm struggled to improve the debt figures because of the high interest it was paying. In April 2019, the company hired restructuring specialist, Alix Partners, to work on its balance sheet and implement cost restructuring plans to help reduce its debt which had increased to £1.6 billion.
- Cash flow generation: Since 2008, the firm had not generated any cash flow apart from 2014, when £35m was generated. It would be useful if the auditor could have highlighted this fundamental risk.
- Excessive borrowing: Despite its higher debt level, the firm had excessive borrowing, e.g. the firm borrowed £1.2m in 2018, resulting in high debt service costs.
- Separately disclosed items in detail: The firm disclosed £1.8bn exceptional items, and the management claimed that was because of business model shifting (non-recurring expenses). Although this risk topic was actually highlighted in the 2018 KAMs, the figures should have been better clarified. According to International Financial Reporting Standards (IFRS), the separation between ongoing expenses and transformation expenses should be justified according to International Financial Reporting Standards (IFRS). Also, the management bonus scheme should consider an allowance for the separately disclosed items.
- Board of directors' bonus scheme: The bonus for the board of directors' policy relied on four factors: cash flow generation, employee turnover, customer satisfaction, and underlying profit (not the actual earnings). The bonus paid over the last five years to the board of directors was £20m due to the use of underlying profit instead of actual profit. Also, £4m was paid in cash for such bonuses. It is

obvious that the board had been actually rewarded for the loss. Besides, the clawback period was only two years if the firm went bankrupt. Therefore, we suggest that the bonus policy should have been linked to the actual profit.

- High Goodwill recognition standards: The management overstated the goodwill for many years. This goodwill was not based on actual profit; as in the previous eight years, no profit had been disclosed apart from the £61m profit in 2015. The firm's goodwill of £2.5bn remained on the balance sheet, although it was based on the earnings forecast of 28% for the following three years. Goodwill should be reflected by customer loyalty and the firm brand. The brand value had recently declined, while the number of customers had shifted to online vacation booking, which had doubled in the UK in 2018. The high goodwill may have contributed to a lack of stakeholders' trust. The firm announced a write-off of £800m goodwill in May 2019, although this step should have been done earlier. The goodwill was not justified in light of the high debt.
- Reforming the business model: A new venture in China and the high debt service cost slowed the process of business transformation, and the auditor suggested that the 28% earnings forecast was doubtful.

4.5 Auditor's responsibility or the auditing standards

Shareholders receive assurance from the audit report, and the auditor's responsibility is to disclose their opinion, which does not force the management to take decisions. In the interim report of May 2019, the last report of the firm, EY mentioned in their review opinion:

"We draw attention to note 1 (page 23) in the financial statements, which indicates that the outcome of the strategic review and the associated conditions in the new financing arrangement is uncertain. As stated in note 1, these events or conditions indicate that a material uncertainty exists. This may cast significant doubt on the company's ability to continue as a going concern. Our conclusion is not modified in respect of this matter."

There is an ongoing investigation regarding the responsibility of the auditor (EY) for the collapse of Thomas Cook (Accountancy Daily 2019; Insider 2019; The Guardian 2019). The media present the stakeholders' opinions; they expect the auditor to warn them and assure them. However, the auditing standards indicate that this is not the auditor's responsibility. The auditor cannot force the management to take action. Also, the auditor can choose the risk topic that can create from his opinion value to the customer. By reading through ISA 701, EY fulfils the requirements of KAMs. Although the opinion was not modified and the firm self-disclosed the financial problem, EY had met the responsibilities required by the ISA 570,700,701. This paper can conclude:

- EY raised the issue of material uncertainty.
- EY raised the going concern issue.
- EY highlighted that the management had raised the financial issues in their interim report.
- EY highlighted a potential manipulation in the previous year's audit report 2018.

Therefore, the independent auditor was not liable for the collapse as the auditor could not force the management to take action.

While the KAMs are to highlight the risk topic related to the firm, the ISA 701 does not provide a detailed guideline for the auditors to follow. The auditors have the free choice to include or exclude any risk topic from the audit report. While in the case of Thomas Cook. The EY had warned the stakeholders of the financial failure, but they did not mention anything regarding the ability of the firm to trade (going concern). It is important to highlight that, according to the ISA701, it is not the auditor's responsibility to protect the stakeholders. The auditors also cannot force the management to take action. The auditor's responsibility is to disclose their opinion. Thomas Cook itself disclosed the financial distress and inability to generate cash in our case. The expectation gap between the auditor and the stakeholders is a standard gap, not a performance gap. It is clear that the differences here are between what the stakeholders want the auditors to do and what the auditors are supposed to do to fulfil the requirements of ISA 701.

5. Conclusions

The paper reviewed the audit report and the KAMs on the annual reports of Thomas Cook Group Plc. The paper shed light on the regulators and the accounting standards board on the consequences of the ISA 701. The paper found that the current new standards were not sufficiently robust to predict the bankruptcy of Thomas Cook Group Plc.

The paper recommends that the auditor should follow the code of ethics and bear in mind the purpose of auditing and the main aim of the accounting standards. As found in other research, the disclosure regulation is not sufficient or credible in the event of a crisis (Merino & Neimark, 1982).

The paper suggests that the ISA 701 KAMs did not represent a fundamental change to the stakeholders. Instead, they reflected a new form of the old-style independent audit report. More needs to be done to restore the confidence and trust in the International Standards of Auditing. The finding supports other research that the KAMs in the independent audit reports tend to confirm the financial position and performance reported by the management in the financial statements, contrary to the intention of the new regulations (Min & Kee, 2019). Thus, the clarity of the KAMs must be improved. This case study's findings should pressure the regulators and the accounting boards to adopt more stringent standards and improve the ISA 701. Any serious neglect by the auditing firm should be considered a financial crime to stop any moral or ethical hazard.

The paper suggests that attention should be focused on the reliability of KAMs specified in ISA 701 as the new audit report failed – in the case reported in this paper – to forecast corporate bankruptcy. The objective should not be to determine whether the firm complied with the new audit regulation but should evaluate the effectiveness of the new audit regulations. The paper analysed the narrative risk disclosure in the KAMs section from the independent audit report. The paper considered neither other parts of the audit report nor other parts of the annual report. Future research could analyse other narrative sections on the annual report, for example, the whole audit report or the management risk report. Also, further research may consider the financial statements and numeric sections related to bankruptcy risks; for example, ALT-MAN Z scores and to what extent the firm disclosed the bankruptcy score and whether this score – if it had been disclosed – would have predicted the bankruptcy. Also, research may look at the forecasting models used in the literature to indicate a financial crisis or bankruptcy, including fuzzy sets, recurrent and multilayer artificial neural networks, and decision trees (Korol, 2019).

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