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An Investigation into the Effect of "Going Concern" Qualifications on the Stock Market

By Betty C. Brown and Alan S. Levitan

The auditor's responsibility when a firm's continued existence is in question was addressed in Statement on Auditing Standards No. 34. Although SAS No. 34 attempts to establish some general guidelines for the auditor to consider in formulating his opinion, it does not offer any specific criteria for the auditor to follow. On the contrary, SAS No. 34 refers to the subjectiveness of the auditor's opinion.

Identifying the point at which uncertainties about recoverability, classifications, and amounts require the auditor to modify his report is a complex professional judgment. No single factor or combination of factors is controlling.¹

After having accumulated all relevant information, the auditor must rely upon his/her own judgment of the materiality of the difficulties. He/she must ultimately determine the extent of disclosure required. If the auditor cannot assuage his/her doubts about continuity, some sort of qualification or disclosure is appropriate. First, however, the auditor will do all that is reasonable to eliminate these doubts, usually relying upon evidence that is persuasive rather than convincing.

Without clearly stated criteria, different auditors might issue different reports on the same firm. It is possible that a "going concern" exception is a self-fulfilling prophecy: firms that otherwise might succeed, could fail *because* of the auditor's report.

Given the possibility that the auditors' report may contribute to a firm's failure, it is difficult to test the superiority of the auditor's ability to predict failure over the investor's ability to predict failure, using only market data. Nonetheless, auditors are forced into the position of "predicting." Moreover, it is asserted that auditors have access to certain "qualitative" (as well as additional quantitative) data that are not contained in the financial statements. Assuming that the market is efficient in the semi-strong form, these "qualitative" data that are not publicly available should be the only factor separating the auditor's predictive ability from the investor's predictive ability.

As an alternative to the "going concern" qualification, these "qualitative" characteristics could be disclosed in the financial statements. It appears appropriate, therefore, to question the influence of the auditors' report on the

behavior of investors. If investors react to a qualified opinion, it may be concluded that they perceive the report to contain information. If they do not, all the concern about self-fulfilling prophecies would be moot. It must be determined whether the report is perceived to contain information before it can be decided if there is a better way of conveying that information.

This study investigates the relationship of going concern qualifications to security price behavior. Because the auditor's report is an integral part of the financial statements, it is necessary to separate the effect of the auditor's report from the effect of the financial statements. This is accomplished by pairing a company receiving a "going concern" qualification with a company having similar financial ratios, in the same industry, and receiving an unqualified opinion.

Differences between stock market reactions of companies receiving "going concern" qualifications and similar companies receiving unqualified opinions were detected. However, the reaction began five weeks prior to year-end, well before the release of the auditor's report, and continued thirty weeks after year-end.

The use of financial ratios as a tool for projecting viability was used in a classic study by Altman.² He developed a model that used five ratios in a single formula derived by multivariate discriminant analysis (MDA). This formula could be applied to the ratios of any single year's financial results. His final function was

$$Z = 1.2X_1 + 1.4X_2 + 3.3X_3 + 0.6X_4 + 1.0X_5 \text{ where}$$

- X_1 = working capital/total assets
- X_2 = retained earnings/total assets
- X_3 = earnings before interest and taxes/total assets
- X_4 = market value of equity/book value of total assets
- X_5 = sales/total assets

He found that a Z score less than 2.675 indicated that a company's financial profile was similar to that of companies which had failed.

The semi-strong form of the efficient market hypothesis, asserting that the prices of securities traded on that market fully reflect all publicly avail-

able information, has received substantial support in the literature. A recent study by Lev and Ohlson³ reviews and summarizes previous market-based accounting research.

Firth⁴ attempted to investigate the impact of qualified opinions on investor decisions. He examined the impact by contrasting the market reactions toward firms receiving qualified opinions with firms in the same industry that received unqualified opinions. He found significant differences in the reactions for firms receiving "going concern" qualifications. The primary problem with his study is that he did not control for the market's response to the financial statements themselves. This omission casts serious doubts on the validity of his findings.

The familiar Market Model has been used to compute residuals. Many market studies have used the popular cumulative-average-residual (CAR) technique, developed by Fama, Fisher, Jensen, and Roll,⁵ of detecting changes in security price behavior.⁶

The period for the test described herein began nine weeks preceding year-end. Residuals were computed and the differences in cumulative average residuals for each pair of companies were analyzed to see if they are significantly different from zero. Differences were tested using the general paired t-test.⁷

The Sample

The NAARS data base for 1978 to 1982 was searched for companies receiving their first going concern exception. Twenty-seven companies were selected. Altman's Z value was computed for each company as a surrogate for its financial condition at the time of the audit exception. Then for each company in the sample, Altman's Z was computed for all companies on Standard and Poor's Industrial COMPUSTAT file according to the following criteria: (1) it must be in the same four-digit SIC code, (2) its year must end within the same COMPUSTAT year, and (3) it must be traded on the NYSE or the ASE. The company with a Z value closest to the original company was declared its match, after determining that the match did not receive a going concern exception. Finally, security returns for all selected com-

	Mean	Standard Deviation	T	p-value
Exception Match	2.35910741 2.21711481	3.11730529 1.46896016	0.2141	0.8316

panies were taken from the Center for Research on Security Prices (CRSP) daily tapes.

Each of the 27 pairs of companies in the sample consists of a company receiving its first going concern exception and its match.

The general t-test was used to compare the means of the Z values for the two groups of companies. Test results for the entire sample failed to reject the null hypothesis that the means of the two groups were significantly different; therefore, it is logical to conclude that the two groups have similar Z values. This supports the underlying premise of the study, that the two groups are from the same population based upon their financial statement characteristics. Moreover, the financial ratios of both groups resemble failed companies.

Results and Conclusions

Results of the t-tests on the differences between the residuals of the companies receiving going concern exceptions and their matches, as illustrated in Figure 1, indicate that the stock market did not react the same to the two types of companies. Residuals of zero indicate the security prices are behaving as expected. Negative residuals reflect a poorer than expected performance and positive residuals show a better than expected performance. Differences between the residuals became significantly different from zero about a month before year-end.

The differences in the residuals were not significantly different from zero for the first five weeks of the period of study. This period was well after the release of the third quarter earnings, but before the release of the year-end information. No information about either category of company should normally have been released

during this period. The reaction occurring immediately after this period was evidently the result of the market's anticipation of the release of the financial statements. Also, leaks about the going concern qualification may have begun prior to year-end.

Generally, the match companies have more internal consistency than the exception companies, suggesting that auditors do not base their exceptions, consistently, on financial characteristics alone. Except for the third week before year-end, standard errors (variances) are higher for the exception companies and, based upon that statistic, the samples represent two different populations.

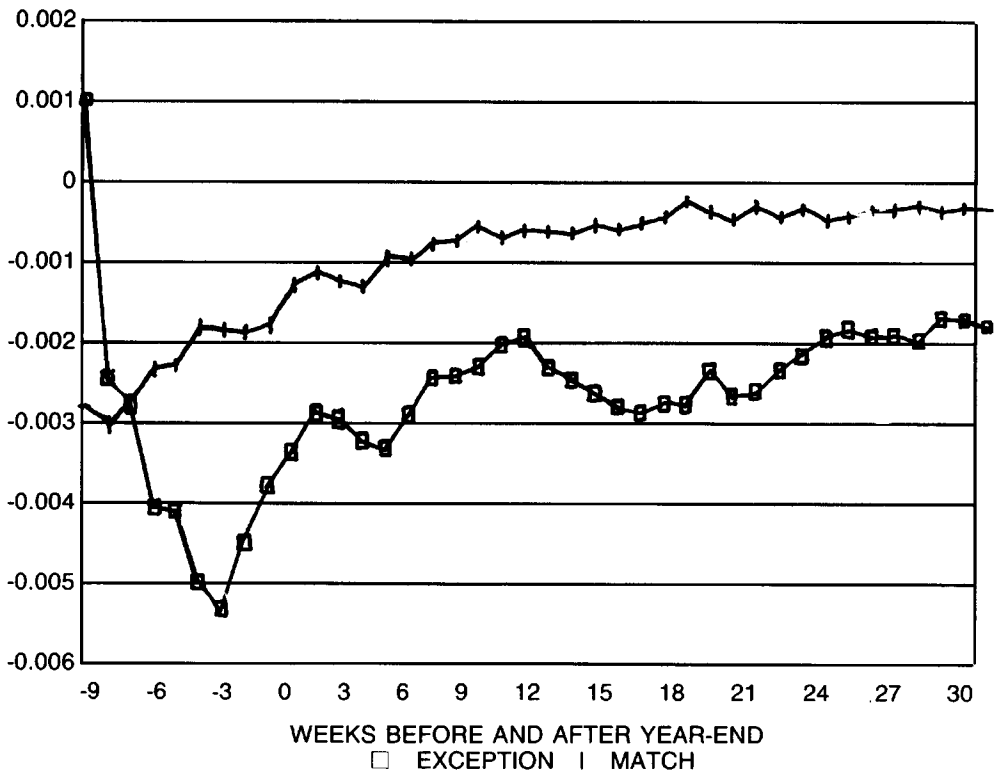
All companies in the experiment exhibit worsening performance during the time period studied as demonstrated by the Residuals graph, Figure 2. However, the performance of those which received going concern exceptions worsened significantly more than that of the companies with matching financial characteristics but more favorable auditors' opinions. These differences occurred early enough, however, to suggest that either (1) the auditor's opinion is a "non-event," or (2) auditors' evaluations of companies are quite similar to those of investors.

It is possible that a "going concern" exception is a self-fulfilling prophecy.

FIGURE 1
Graph Of The Differences Using
The Cumulative-Average-Residual Technique



FIGURE 2
Graph Of The Cumulative-Average-Residuals



There were strong downward movements in the CARs of the exception companies prior to year-end and another slight downward fluctuation immediately after year-end, possibly indicating negative expectations about the contents of the financial statements. On the other hand, the CARs of the match companies steadily increased from about two months prior to year-end until six weeks afterwards, indicating increasingly optimistic expectations about the contents of the financial statements. This suggests that the uncertainty preceding the release of the annual report was greater for the exception companies than it was for the match companies. This could have been related to "leaks" about either the financial condition of the companies or the possibilities of unfavorable opinions.

Nine weeks after year-end, when many companies would have released their financial statements, the CARs of the match companies receiving "clean" opinions stabilized at slightly below zero and remained relatively constant for the remainder of the period of study, thus indicating that the standard auditor's report had no effect on investor behavior. Figure 2 depicts this trend. Since the match companies have financial statements similar to companies receiving going concern exceptions, it is not surprising that the CARs after the release of the financial statements are negative. This indicates that there is some information content to the financial statements themselves.

The CARs for companies receiving going concern exceptions are relatively more volatile over time than their clean opinion counterparts. Although there was some leveling after week six, there was considerably more variability over time in the CARs of the exception companies. Also, the residuals were more negative for the exception companies, suggesting that investors were reacting negatively to the contents of the annual report. Since the financial statements of the exception companies are similar to the financial statements of the match companies, the most obvious differences in the two sets of financial packages is the auditor's report. It appears that investors are reacting to the auditor's report, or to nonfinancial contrary information upon which the report is

based, rather than simply to the financial statements.

Of course, going concern exceptions may affect a company's ability to obtain additional credit, and investors may have been reacting to the anticipation of more restrictive credit. This returns to the self-fulfilling prophecy issue. If an investor perceives that a going concern exception causes damage to a company's credit position by a greater degree than the financial statement ratios, this, in turn, will affect security price behavior.

Further studies are needed to examine the effect of a going concern exception on creditors' decisions. Would a company that otherwise may be able to obtain additional debt financing be denied on the basis of a going concern exception? If so, bankers might need more disclosure with respect to auditors' conclusions. In any event, a going concern exception does appear to signal increased difficulties in raising capital in the equity market.^Ω

NOTES

¹ American Institute of Certified Public Accountants, *Statement on Auditing Standards No. 34: The Auditor's Considerations When a Question Arises About an Entity's Continued Existence* (AICPA, 1981).

² E. I. Altman, "Financial Ratios, Discriminant Analysis and the Prediction of Failure," *Journal of Finance*, September 1968, pp. 589-609.

³ B. Lev, and J. A. Ohlson, "Market-Based Empirical Research in Accounting: A Review, Interpretation and Extension," *Journal of Accounting Research*, vol. 20, Supplement 1982, pp. 249-322.

⁴ M. Firth, "Qualified Audit Reports: Their Impact on Investment Decisions," *The Accounting Review*, July 1978, pp. 642-650.

⁵ E. F. Fama, L. Fisher, M. C. Jensen and R. Roll, "The Adjustment of Stock Prices to New Information," *International Economic Review*, February 1969, pp. 1-22.

⁶ The Market Model is defined as:

$$R_{it} = \alpha + \beta R_{mt} + \epsilon_{it}$$

where:

- R_{it} = $(P'_{it} - P_{it-1}) / (P_{it-1})$ = The rate of return of security i in period t.
- P'_{it} = The price of security i, adjusted for dividends, splits and new offerings, at period t.
- P_{it} = The price of security i at period t.
- α = The intercept and slope of the linear relationship between R_{it} and R_{mt}
- R_{mt} = The return on the market in period t.
- ϵ_{it} = The residual or the individual component of the return on security i in period t.

⁷ The paired t-test can be mathematically stated as:

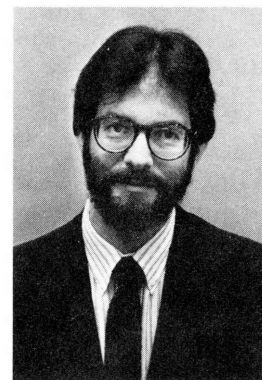
$$\sqrt{\frac{d}{S_d^2/n}}$$

where:

- \bar{d} = mean difference
- S_d = the standard deviation
- n = the number of pairs



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