Marquette University
e-Publications@Marquette

Accounting Faculty Research and Publications

Business Administration, College of

10-1-2003

Going-Concern Opinions: Broadening the Expectations Gap

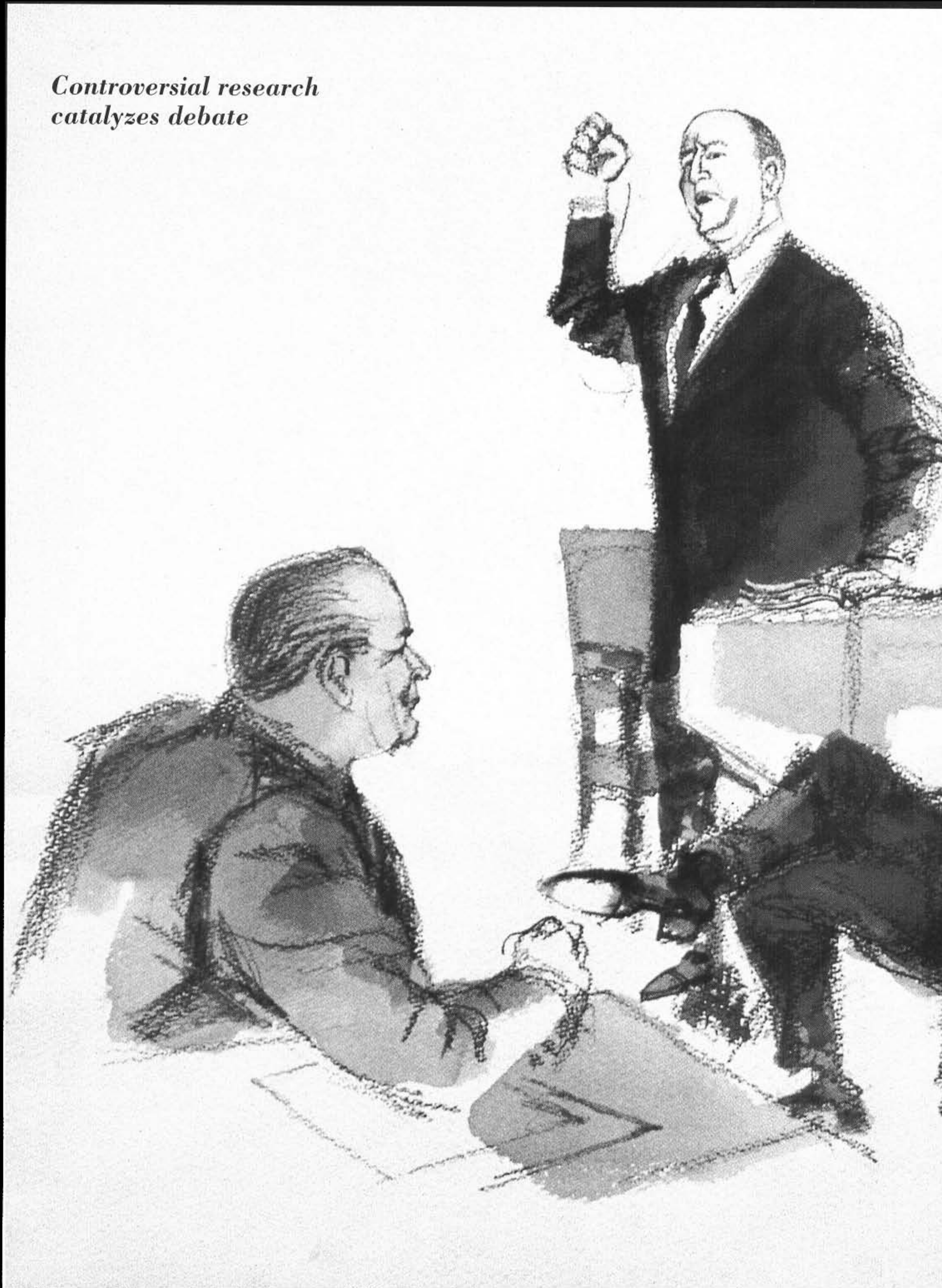
Michael D. Akers
Marquette University, michael.akers@marquette.edu

Meredith A. Maher
Marquette University

Don Giacomino
Marquette University, don.giacomino@marquette.edu

Published version. *The CPA Journal*, Vol. 73, No. 10 (October 2003): 38-42. Permalink.

Controversial research catalyzes debate



Going-Concern *Opinions:*

Broadening the Expectations Gap

By Michael D. Akers, Meredith A. Maher, and Don E. Giacomino

In Brief

Taking the Weiss Report to Task

A rash of high-profile bankruptcies has led to a search for answers. Many hold auditors responsible for not detecting the potential for bankruptcy during the most recent audit. The Weiss Report, a study of several dozen bankrupt companies submitted to the U.S. Senate during its deliberations on the Sarbanes-Oxley Act, found a "broad and massive failure" on the part of auditors to raise "yellow flags" that indicate potential bankruptcy. The authors examined Weiss' methodology and found that, applied to a broader group of companies, Weiss' criteria would have incorrectly predicted bankruptcy for nearly half of the non-bankrupt companies studied. This failure to accurately predict undermines the credibility of the subsequently enacted legislation.

Public criticism of auditors has focused on not only their responsibility for fraud, but also their responsibility to issue a going-concern opinion when a business is about to fail. In the wake of many high-profile bankruptcies, many have asked why auditors didn't warn investors. The degree of blame that should be placed on auditors for not detecting fraud is an important one, and it has been the subject of much research. Perhaps the most interesting and important study on bankruptcy and auditors' going-concern opinions is the study conducted by Weiss Ratings Inc. Weiss submitted its July 5, 2002, report, "The Worsening Crisis of Confidence on Wall Street," to the U.S. Senate while it was deliberating the bill that would become the Sarbanes-Oxley Act.

The Weiss Report is highly critical of auditing firms, especially the then–Big Five. The report not only describes the research methodology and results of their study of selected bankrupt companies, but it also criticizes auditors for not recognizing going-concern situations and not predicting bankruptcy for audit clients that later went bankrupt. The report concluded, "The data demonstrate a broad and massive failure by auditors to adequately detect and warn of accounting irregularities and bankruptcies."

The authors have concluded that the information presented in the Weiss research does not support the report's conclusion, and could have invalidly supported certain parts of the Sarbanes-Oxley Act.

The Weiss Report

The Weiss Report, submitted to the U.S. Senate, made the following observations:

> [F]or shareholders seeking protection, Wall Street research analysts are merely the second line of defense. The first line of defense is manned by public auditors, the subject of this paper. … Herein, we examine auditing firms in two closely related areas: (a) in terms of their performance in warning the public of accounting irregularities; and (b) in terms of their performance in warning of bankruptcies.

The Weiss Report concluded that "The data demonstrate a broad and massive failure by auditors to adequately detect and warn of accounting irregularities and bankruptcies as the first line of defense against precisely such problems." This conclusion was based upon the number of "yellow flags" that selected bankrupt companies had with respect to their financial condition. The reader is led to believe that the Weiss model (two out of seven yellow flags) is a reliable and widely accepted method for anticipating bankruptcy.

SAS 59

Statement on Auditing Standards (SAS) 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, was issued over a decade ago in response to increasing concerns about whether auditors had been taking sufficient responsibility for evaluating a client's ability to continue as a going concern. Since the issuance of SAS 59, auditors have sought guidance in making going-concern decisions (see the *Sidebar*).

SAS 59 states that the auditor has a responsibility to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern for a period not to exceed one year from the date of the financial statements being audited. Auditors are not responsible for predicting future events or conditions. Weiss implies and assumes that the auditors failed because a going-concern report was not issued for selected companies that later went bankrupt. SAS 59 notes "[that] an entity may cease to exist as a going concern subsequent to receiving a report from the auditor [which] does not refer to substantial doubt, even within one year following the date of the financial statements, does not, in itself, indicate inadequate performance by the auditor." The standard also states that the absence of such a reference to substantial doubt in the audit report should not be considered "providing assurance as to an entity's ability to continue as a going concern."

An auditor is not required to design audit procedures solely for the purpose of determining whether there is substantial doubt that an entity will continue as a going concern. Audit procedures designed for other audit objectives, such as analytical procedures and review of compliance with debt and loan covenants, are considered sufficient. In performing these procedures, there are conditions and events that could indicate that there is substantial doubt an entity will continue as a going concern. Examples of such items listed in SAS 59 include negative trends (e.g., working capital deficiencies; negative cash flows from operations); indicators of financial difficulties (e.g., default on loan agreements); internal matters (e.g., labor difficulties); and external matters (e.g., legislation that might affect an entity's ability to operate).

The Weiss Report notes that there was evidence of negative trends for all the bankrupt companies it examined. Although Weiss concludes that the existence of two yellow flags (negative ratios) out of seven is an indication of substantial doubt, there is nothing in SAS 59 or any other authoritative literature to support this contention.

If the conditions or events identified in SAS 59 exist, the auditor is required to evaluate management's plans for dealing with the impact of these items, such as: disposing of assets; borrowing money or restructuring debt; reducing or delaying expenditures; and increasing ownership equity. If, after evaluating management's plans, the auditor concludes that there is substantial doubt an entity will continue as a going concern, the auditor must consider the impact on the financial statements and the appropriateness of the related disclosures. Under SAS 59, disclosures could include: conditions and events giving rise to the assessment of substantial doubt about the entity's ability to

SAS 59 REQUIREMENTS

- An auditor's responsibility to evaluate whether an entity is a going concern is for a period not to exceed one year from the date of the audited financial statements.
- Auditors are not responsible for predicting future events.
- The subsequent bankruptcy by a company that did not receive a going-concern report, even if it is within one year of the balance sheet date, does not necessarily mean inadequate performance by the auditor.
- An auditor is not required to perform specific procedures to determine if an entity is a going concern. Audit procedures for other audit objectives are considered sufficient.
- An auditor is required to evaluate management's plans to mitigate conditions and events that indicate there might be substantial doubt that an entity is a going concern.
- If the auditor concludes there is substantial doubt, the auditor must consider the impact on the financial statements and related disclosures, to determine the effect on the audit opinion.
- There are specific documentation requirements associated with the assessment of an entity's ability to continue as a going concern. ❑

continue as a going concern; the possible effect of such conditions and events; management's evaluation of the significance of those conditions and events; and mitigating factors.

The Weiss Report fails to address the auditor's evaluation of management's plans, an aspect of the audit process that researchers have found difficult to model. If the auditor concludes there is substantial doubt, an explanatory paragraph is added after the opinion paragraph. The phrase "substantial doubt about its ability to continue as a going concern," or something similar, is used. Inadequate disclosure with respect to an entity's ability to continue as a going concern could result in a qualified or adverse opinion. An auditor's responsibility is to render an opinion as to whether a company's financial statements and related disclosures are fairly stated. Weiss does not indicate whether the financial statement disclosures were examined to determine whether such disclosures adequately supported the opinion rendered.

SAS 59 also requires an auditor to document the following items: the conditions or events that indicate a substantial doubt about an entity's ability to continue as a going concern; the elements of management's plans that the auditor considered to be particularly significant to overcoming the adverse effects of the conditions; the auditing procedures performed and evidence obtained to evaluate management's plans; the auditor's conclusion as to whether substantial doubt about the entity's ability to continue as a going concern is alleviated; and the auditor's conclusion as to whether an explanation in the auditor's report is necessary.

Research Background

The Weiss Report identified 307 companies that declared bankruptcy between January 1, 2001, and June 30, 2002, from which Weiss eliminated all companies that declared bankruptcy more than a year after the date of the most recent financial statements (the SAS 59 time limitation). Weiss also eliminated all companies that did not receive a "clean bill of health," meaning an unqualified opinion with no mention of going-concern problems. This left only 45 companies that went bankrupt after having received an unqualified audit report.

In the study, seven financial ratios were computed based on the financial statements for the fiscal period immediately preceding the company's bankruptcy. These ratios were:

- Cash flow from operations to total debt
- Net working capital to total assets
- Debt to equity
- Return on equity
- Current ratio
- Net income to sales
- Cash flow to current liabilities.

Weiss indicated that auditors currently have only two choices when issuing their audit reports: submit a clean bill of health (a "green light"), or raise going-concern issues (a "red flag"). Weiss recommended that an additional, intermediate level of warning be made available for public companies, and suggested language for this warning: "The company is currently stable but may suffer financial pressures if the business environment deteriorates within the next 12 months. This level of warning alerts shareholders and regulators but does not invoke SEC actions." The label for this intermediate level is a "yellow flag." Using specific quantitative benchmarks for each of the seven ratios, Weiss counted the number of yellow flags for each of the companies and reported their frequency distribution.

The Weiss research has numerous and important limitations:

- The seven ratios used by Weiss were based on individual ratios that have not been proved to predict bankruptcies. In addition, the ratios appear to have been selected arbitrarily from several sources, with arbitrary cutoffs that are not accepted industry standards. Weiss cites three sources for choosing the ratios: a study by Mills and Yamamura (*Journal of Accountancy*, October 1998); the 1966 Beaver study; and a page reference in a 1974 text by Bernstein on financial statement analysis. First, the Mills and Yamamura article suggests ratios that might be useful for auditors in forming their going-concern decisions. The article neither tests for nor proves any relationships between the ratios and bankruptcy. Second, the Beaver study does not use individual ratios; rather, it tests the predictive ability of a group of ratios. Third, the reference in the Bernstein text relates to bankruptcy prediction studies by Altman. Altman's Bankruptcy Prediction Model and the Koh methodology have been proved to reliably predict bankruptcies. Weiss did not use either of those models, however, which use a group of ratios collectively to predict bankruptcy, not individual ratios as in Weiss.

■ The Weiss Report covered only selected bankrupt companies. There was no comparison between bankrupt and nonbankrupt companies. Such an analysis would have provided evidence whether or not these ratios differentiate bankrupt from nonbankrupt companies.

■ Weiss asserted that the seven financial ratios used in the study are "commonly used by auditors to help flag difficulties." There is no empirical evidence, however, that auditors use these ratios for that purpose. Nor is there evidence that these individual ratios have been determined to be valid for predicting financial distress or bankruptcy.

■ The 45 companies selected went bankrupt without their auditors issuing a going-concern opinion. Weiss did not include the cases in which auditors had issued such an opinion.

■ The study did not include qualitative measures, such as bond defaults or off-balance sheet financing, or professional judgment in auditors' decisions. These factors have to be integrated into the decision process. If predicting bankruptcies were as easy as computing seven basic ratios, then there would be no need for an auditor's professional judgment.

Testing the Conclusions

To determine if the seven Weiss criteria could predict bankruptcy, the authors applied them to a sample of nonbankrupt companies. The intention was not to analyze the Weiss Report, but merely to apply its ratios and yellow flags. The results may prove unsettling to the accounting profession and, possibly, to some members of Congress.

The authors examined 3,610 active nonbankrupt public companies as well as 97 bankrupt public companies in order to determine if the Weiss ratios could accurately predict bankruptcy. Unlike Weiss, which included only companies where the auditors did not correctly predict the bankruptcy, this survey included all public companies filing for bankruptcy in 2000 that had filed a 10-K in the previous two years.

> The flaws of the Weiss Report suggest that the study cannot be relied upon as an indicator of the success or failure of auditing firms to predict the bankruptcy of a company.

Weiss' Appendix A fully documented the criteria for the seven ratios. The authors drew active nonbankrupt companies from Compustat, using 2000 and 2001 annual financial data, exactly as Weiss had done, in order to compute the number of yellow flags for each ratio. From these results, the authors determined that the Weiss criteria (two yellow flags) would have predicted that 46.9% of nonbankrupt companies should have received a going-concern opinion due to potential financial failure. In other words, the Weiss criteria would have incorrectly predicted bankruptcy for 1,693 companies. Just as a correct prediction of bankruptcy is desirable, an incorrect prediction of bankruptcy has negative consequences for the company, its auditor, and its shareholders. Taken to the extreme, the most foolproof way to predict all bankruptcies is to predict that all companies will go bankrupt, ignoring the significant number of incorrect predictions in the process. The Weiss research ignores the risk of incorrect predictions of bankruptcy.

The Weiss Report's conclusion of "a broad and massive failure by auditors to adequately detect and warn of accounting irregularities and bankruptcies." cannot be taken lightly. It is reasonable to assume that Weiss affected the view of the U.S. senators and other parties that read the study. Weiss proposed seven measures, three of which relate to consulting services. The Sarbanes-Oxley Act has specific provisions that restrict consulting work that auditors can provide for their clients.

Studies offered in support of federal legislation should be conducted using proper criteria and research methodology. New legislation or audit regulations should not be an overreaction to highly publicized cases (e.g., Enron and WorldCom) unless these are indicative of a systemic problem. In addition, conclusions should be based on the data and use appropriate statistical tests. The flaws of the Weiss Report—inadequate sample selection; the use of criteria not proved to predict bankruptcy; and the lack of statistical support—suggest that the study cannot be relied upon as an indicator of the success or failure of auditing firms to predict the bankruptcy or the going-concern status of a company. If Weiss' standard of two yellow flags were applied to all companies, auditors would be predicting that almost half of their clients would go bankrupt.

The Weiss conclusions represent a widening of the gap between expectations of auditors' responsibilities and the responsibilities auditors actually assume. Because of this expectations gap, the public often assumes that an auditor has failed to perform adequately. The unfortunate repercussions of studies like Weiss, which in fact spurred new laws and regulations, lead to increased costs of audit compliance without delivering any improvement in the prediction of bankruptcies. ❑

Michael D. Akers, PhD, CMA, CIA, CFE, CPA, *is the Charles T. Horngren Professor of Accounting,* ***Meredith A. Maher, MSA, CPA,*** *is a research assistant for the department of accounting, and* ***Don E. Giacomino, PhD, CPA,*** *is professor and chair of the department of accounting and holds the Donald and Beverly Flynn Chair in Accounting, all at the college of business administration, Marquette University, Milwaukee, Wis.*