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Weighing the Public Interest

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Weighing the Public Interest

Is the Going Concern Opinion Still Relevant?

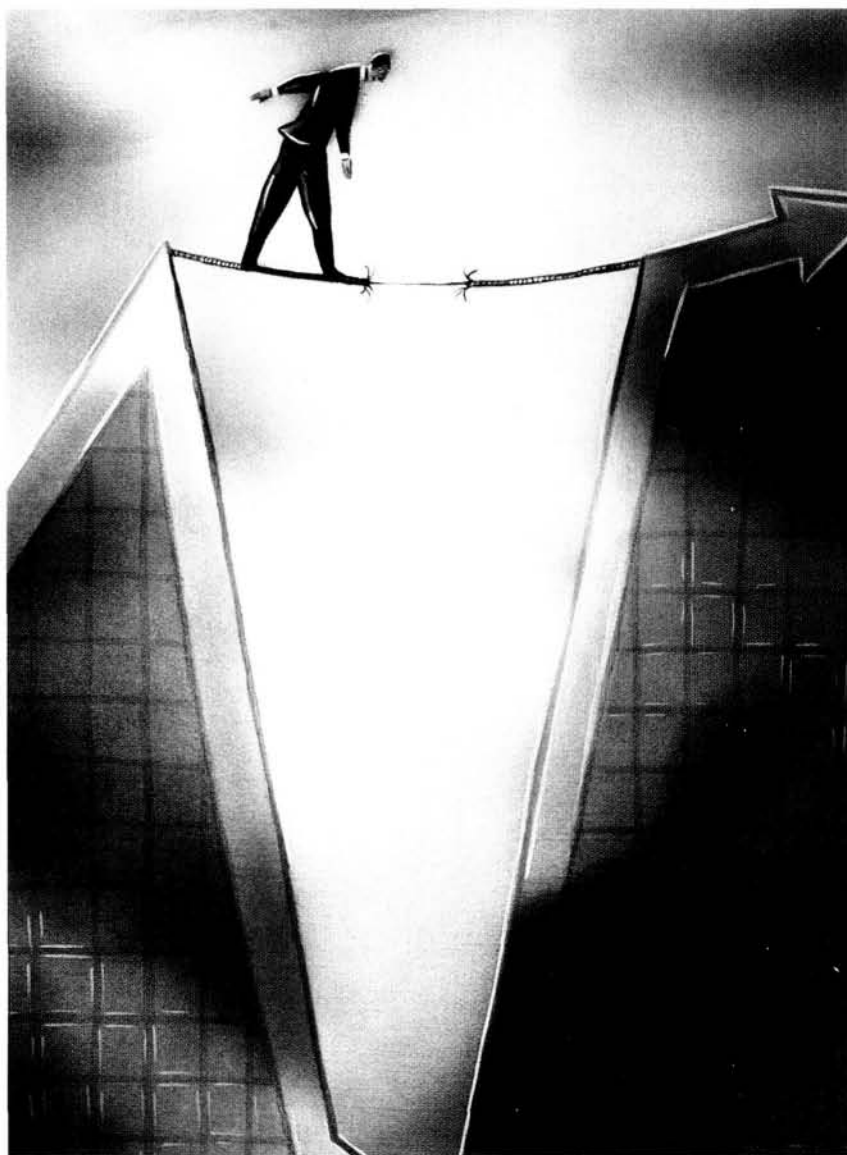
By Jodi L. Bellovary,
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In 1981, the AICPA addressed the issue of going concern status through SAS 34, *The Auditor's Considerations When a Question Arises About an Entity's Continued Existence*. In 1988, the AICPA issued SAS 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, which remains the authoritative guidance. To determine if additional guidance on the topic of going concern is provided by accounting organizations, the authors contacted the AICPA and the state CPA societies (50 of 51 responded, including Washington, D.C.). The authors found that none of these organizations provide additional literature or guidance in this area.

Despite the preponderance of evidence suggesting that the going concern opinion lacks significant informative value, several individuals have called for additional guidance in the area of going concern. With each company failure shortly after the issuance of a non-going concern audit report, the public asks the question: "Where were the auditors?" Conversely, a survey of auditors found that the majority of respondents consider current standards sufficient. Auditors believe that going concern assessment requires significant judgment and that each case must be reviewed on an individual basis.

Authoritative Literature

Prior to SAS 34, the authoritative literature provided little guidance on when the



auditor should consider modifying the audit opinion based on uncertainty that the entity could continue as a going concern. SAS 34 was issued in response to the preponderance of cases where the auditor's judgment was called into question after a business failure. SAS 34 in para-

graphs 7 and 8 required auditors to consider contrary information and mitigating factors, and in paragraph 3 required management's plans when evidence of audit procedures suggested there may be a question as to the company's ability to continue as a going concern. According to

paragraph 4, contrary information included negative cash flow from operations, recurring operating losses, debt default, loss of key personnel, and litigation. Paragraph 5 presents mitigating factors that may offset the effects of contrary information, including the ability to dispose of assets, the availability of sources for borrowing or capital, and the capability to reduce expenses or delay expenditures. Paragraph 9 required auditors to review management's response to the contrary information (plans for asset disposal, borrowing, or delay of expenditures) to assess the effects and feasibility of the plans. Based on this evaluation, the auditor must judge the appropriateness of modifying the audit opinion to indicate an uncertainty about the entity's going concern status (paragraph 11).

Problems continued after the issuance of SAS 34: "Questions [remained] about whether auditors had been taking sufficient responsibility for evaluating a client's ability to continue in existence" ("Documenting Compliance with SAS 59," by Fred Goldstein, *The CPA Journal*, July 1989). Furthermore, companies were still failing after receiving an unqualified audit opinion. SAS 59 was one of the nine "expectation gap auditing standards" issued in 1988 to address the differences between public expectations and auditors' responsibilities. SAS 59 increases the auditor's responsibility for going concern evaluation in an effort to improve external auditor communications. Some, however, believe that SAS 59 adds little to the authoritative guidance. In "Going-Concern Audit Report Recipients Before and After SAS No. 59" [*The National Public Accountant* 43 (8): 24-25 (1998)], Marshall K. Geiger, Kannan Raghunandan, and Dasartha V. Rama state that going concern assessment was a part of practice before SAS 59, saying the statement "appears to have only codified existing practice." The authors attempted to gain more information from the AICPA on the response to the issuance of SAS 59 through the original comment letters; unfortunately, they are no longer available.

There are three noteworthy changes from SAS 34 to SAS 59. [See "The Expectation Gap Auditing Standards," by Dan Guy and J. Sullivan, *Journal of Accountancy* 165 (4) 1988; "The

Auditor's Going-Concern Decision: A Review and Implications for Future Research," by S. Asare, *Journal of Accounting Literature* 9: 39-64, 1990; "How to Evaluate Going Concern," by J. Ellingsen, Kurt Pany, and P. Pagan, *Journal of Accountancy* 167 (1) 1989; "Understanding SAS No. 59: The Auditor's Going Concern Responsibilities," by S. Robison, *The Practical Accountant* 22 (9) 1989.] First, SAS 59 requires auditors to consider going concern status for every audit engagement. SAS 34 required going concern consideration only when audit procedures indicated that there may be a question as to the company's going concern status. SAS 59, paragraph 5, does not require, however, that audit procedures be designed specifically to address the going concern issue. Therefore, the change from SAS 34 to SAS 59 is not a requirement of additional audit procedures, but rather a requirement of going concern consideration in every audit. Second, SAS 59 requires that the audit report be modified if there is substantial doubt about the entity's going concern status. SAS 34 required a qualified audit report if there was uncertainty regarding the recoverability of assets and the classification of liabilities. Third, SAS 59 requires an explanatory paragraph in the audit report regarding the substantial doubt; SAS 34 merely required a qualified "subject to" opinion.

The Impact of SAS 34 and SAS 59

Several studies have been conducted to determine how SAS 34 and SAS 59 affect audit reports. As the authoritative guidance places more responsibility on auditors, one would expect auditors to issue more going concern-modified audit reports [see Joseph V. Carcello, Dana R. Hermanson, and H. Fenwick Huss, "Temporal Changes in Bankruptcy-Related Reporting," *Auditing: A Journal of Practice and Theory* 14 (2) 1995, and Raghunandan and Rama, "Audit Reports for Companies in Financial Distress: Before and After SAS No. 59," *Auditing: A Journal of Practice and Theory*, 14 (1) 1995]. The work of Raghunandan and Rama supports this expectation; they found that auditors are more likely to issue going concern opinions post-SAS 59 than pre-SAS 59.

Carcello et al. provide evidence that auditors were more likely to issue going concern-modified audit reports post-SAS 34 than pre-SAS 34. Contrary to Raghunandan and Rama's results, however, Carcello et al. found the likelihood to modify audit reports is not significantly different when comparing pre-SAS 59 to post-SAS 59. Geiger et al. reported similar results, and found that the mean probabilities of bankruptcy pre SAS 59 and post SAS 59 are not significantly different. They go on to state that this "indicat[es] that auditors [are] not issuing going-concern modified opinions to differently stressed clients after the implementation of SAS No. 59."

Other studies that investigated whether the going concern opinion adds value to the decision-making process have yielded mixed results. Kevin C.W. Chen and Brian K. Church found that the market's reaction is less severe when a going concern opinion has been issued as opposed to when a non-going concern opinion has been given. They concluded

Studies that investigated whether the going concern opinion adds value to the decision-making process have yielded mixed results.

that the going concern opinion has informative value to explain excess returns around a bankruptcy filing. [See "Going Concern Opinions and the Market's Reaction to Bankruptcy Filings," *The Accounting Review* 71 (1) 1996. See also Peter Dodd, Nicholas Dopuch, Robert Holthausen, and Richard Leftwich, "Qualified Audit Opinions and Stock Prices," *Journal of Accounting and*

Economics 6 (1) 1984; Dopuch, Holthausen, and Leftwich, "Predicting Audit Qualifications with Financial and Market Variables," *The Accounting Review* 62 (3) 1987; Michael Firth, "Qualified Audit Reports: Their Impact on Investment Decisions," *The Accounting Review* 53 (3) 1978; Lon Holder-Webb and Mike Wilkins, "The Incremental Information Content of SAS No. 59 Going-Concern Opinions," *Journal of Accounting Research* 38 (1) 2000; and William Hopwood, James McKeown, and Jane Mutchler, "A Test of the Incremental Explanatory Power of Opinions Qualified for Consistency and Uncertainty," *The Accounting Review* 64 (1) 1989.]

Betty C. Brown and Alan S. Levitan ["An Investigation into the Effect of

no valuable information to the decision-making process. Clive S. Lennox ["The Accuracy and Incremental Information Content of Audit Reports in Predicting Bankruptcy," *Journal of Business Finance & Accounting*, 26 (5-6) 1999] found that a change in going concern qualification has no significant impact and therefore concluded that the audit report modified for going concern does not provide valuable information. [See also Max Bessell, Asokan Anandarajan, and Ahson Umar, "Information Content, Audit Reports and Going-Concern: An Australian Study," *Accounting and Finance*, 43, 2003; R.R. Davis, "An Empirical Evaluation of Auditors' Subject-to Opinions," *Auditing: A Journal of Practice & Theory*, 2 (1) 1982; R.Z. Elias and J. Johnston, "Is

of the Going-Concern Status of an Audit Client," *Journal of Business Finance & Accounting*, 17 (2) 1990] asserted that the problems with SAS 34 continue to appear with SAS 59 because the statements contain essentially the same guidance. This assertion would appear valid given that the same questions that arose after SAS 34 was released continue to be asked post-SAS 59:

- Where are the auditors?
- Why are businesses failing shortly after receiving an audit report that does not indicate substantial doubt about the entity's ability to continue as a going concern?
- Are auditors taking enough responsibility for going concern assessment?

Jonathan Weil ("Going Concerns'-- Did Accountants Fail to Flag Problems at Dot-com Casualties?" *Wall Street Journal*, February 9, 2001) reported that during the wave of "dot com" failures in 2000, only three of the 10 publicly held dot com companies that filed for bankruptcy received going concern opinions on their most recent audit report. In some cases, the going concern opinion comes too late. Weil referred to one case in which the company had a fiscal year ending in June. The company received a going concern opinion released in October, and went bankrupt in November. Another critic, Martin D. Weiss of Weiss Ratings, Inc., in "The Worsening Crisis of Confidence on Wall Street" (2002), stated that more than 40% of public companies that filed for bankruptcy between January 1, 2001, and June 30, 2002, received unqualified opinions on their most recent audit report. Weiss called this a "breakdown with disastrous consequences" and recommended creating a clearer definition of the auditor's responsibility. Weiss submitted his report to the U.S. Senate during its debate of the Sarbanes-Oxley Act (SOA), in support of the new legislation. The Senate used Weiss' report as part of the consideration for the controls put in place by SOA. If the situation is so "disastrous," why did Congress not factor the issue of going concern assessment into the new legislation?

Elizabeth Venuti, in "The Going-Concern Assumption Revisited: Assessing a Company's Future Viability" (*The CPA Journal*, May 2004), reported

More than 40% of public companies that filed for bankruptcy between January 1, 2001, and June 30, 2002, received unqualified opinions on their most recent audit report.

'Going Concern' Qualifications on the Stock Market," *The Woman CPA*, 48 (3) 1986] reported that companies that receive going concern opinions show significantly poorer market performance than companies that do not receive going concern opinions. Brown and Levitan, however, concluded that the auditor's opinion may not be the only factor affecting performance, because the differences in performance begin three to five weeks prior to year-end. [See also C. Chow and S. Rice, "Qualified Audit Opinions and Share Prices—An Investigation," *Auditing: A Journal of Practice & Theory*, 1 (2) 1982.]

The preponderance of evidence suggests that the going concern opinion adds

There Incremental Information Content in the Going Concern Explanatory Paragraph?" *Advances in Accounting*, 18, 2001; and J. Elliott, "'Subject to' Audit Opinions and Abnormal Security Returns—Outcomes and Ambiguities," *Journal of Accounting Research*, 20 (2, II) 1982.]

Arguments for Additional Guidance

Despite evidence suggesting that the going concern opinion does not have informative value, several individuals have criticized the current literature and called for additional guidance in the area of going concern. Hian Chye Koh and Larry N. Killough ["The Use of Multiple Discriminant Analysis in the Assessment

that, post-SAS 59, nearly 50% of bankrupt companies did not receive a qualified going concern opinion on their most recent audit report. She also points out that "twelve of the 20 largest bankruptcy filings in U.S. history took place in 2001 and 2002," and that none of the 12 received qualified going concern opinions on their most recent audit report. Venuti believes the issue goes much deeper, stating "modifications to the concept statements and auditing standards appear to be necessary." She refers to the International Standards on Auditing (ISA), which provides in its glossary the following definition of the going concern assumption:

Under the going concern assumption, an entity is ordinarily viewed as continuing in business for the foreseeable future with neither the intention nor the necessity of liquidation, ceasing trading, or seeking protection from creditors pursuant to laws or regulations. Accordingly, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business.

Venuti questions whether companies such as WorldCom and Enron would have received a going concern opinion had SAS 59 used "similar language."

Practitioners' Views on the Need for Additional Guidance

Given the published criticism of the current authoritative guidance, the authors decided to obtain professionals' points of view regarding the authoritative guidance relating to going concern. The authors surveyed the top 100 accounting firms (in 2004, according to *Accounting Today*) regarding the firms' policies and procedures for assessing the going concern status of clients. *Exhibit 1* presents the survey results.

Of the 22 respondents that use a formal checklist to assess the going concern status of clients, 15 use Practitioners Publishing Company's (PPC) Going Concern Checklist CX-19, a standardized questionnaire that outlines the guidance in SAS 59. Seven of the respondents had developed internal checklists. (One respondent uses the PPC checklist as well as an internally generated checklist; one did not provide a copy of the checklist used.) Four

of the internally generated checklists closely follow SAS 59, similar to the PPC checklist.

Seven of the 26 respondents indicated a desire for additional professional guidance. Two respondents communicated confusion as to whether the one-year timeframe used for going concern evaluation extends from the financial statement date or from the audit report date, and wanted additional guidance on the timeframe to be considered. One respondent wanted to see more practical considerations and specific guidance. Another respondent expressed a desire for additional guidance on how to deal with clients on this issue.

The majority of respondents (19 of 26), however, believed that current authoritative guidance in this area is sufficient and did not want to see additional professional guidance. The overwhelming response was that going concern is an area requiring significant judgment. These respondents believed that each case was unique, requiring individual consideration. Cassell Bryan-Low, in "Auditors Fail to Foresee Bankruptcies" (*Wall Street Journal*, July 11, 2002), reported similar reactions from practice: "A KPMG spokesman ... said ... 'the going-concern clause ... requires a great deal of judgment and is not something to be taken lightly.'" The spokesman also pointed out that critics make "unfair conclusions based on a tiny percentage of the thousands of audits performed each

year by the profession," thus raising the question, "Is there really a need for additional guidance, or are critics referring to isolated situations?"

Is Litigation a Concern?

In the case of a business failure, auditors are exposed to the risk that financial statement users will sue them for not issuing a going concern opinion to warn users that the entity may not continue in existence for another year beyond the date of the audited financial statements. There is also the chance that a company will sue its auditor for issuing a going concern opinion "in error" (i.e., when the client does not fail). To assess the risks of litigation, the authors searched for data regarding auditor litigation cases and outcomes. They began with searches of Internet search engines, journal/newspaper databases, and the SEC website for the topics of "going concern" and "auditor litigation." The authors also contacted the SEC directly via telephone to substantiate the findings of the SEC website search, which returned no instances of auditor litigation for going concern issues. Per the conversation with the SEC, auditor litigation for going concern issues is not a primary concern or focus for the SEC.

The authors also searched the auditor litigation database compiled by Zoe-Vonna Palmrose ("Empirical Research in Auditor Litigation: Considerations and Data," *Studies in Accounting Research* #33,

EXHIBIT 1
Survey of Top 100 Accounting Firms

Question	Firms Responding (26 total)	
	Yes	No
Does your firm currently use a formal checklist to assess the going concern status of your clients?*	22	4
Do you believe that current authoritative guidance in this area is sufficient?	21	45
Would you like to see additional professional guidance on how to evaluate going concern status?	7	19

* One respondent that indicated the use of a checklist is optional is included among "Yes" respondents.

American Accounting Association, 1999), which includes 1,071 instances of auditor litigation involving the Big Eight firms and audits from 1960 through 1995. A keyword search of "going concern" returned 41 cases, 14 of which were fraud-related, where fraud was the primary focus of the case; the going concern issue played a secondary role. In fraud cases, the procedures for evaluating going concern status are not useful and the opinion is not meaningful. A review of the 27 cases that were not fraud-related showed that 10 had going concern as a primary issue, not just as part of a long list of other issues. In five of the 10 cases, the case was either dismissed or the auditor was not held liable. In three of the cases, the auditors settled for amounts up to \$5 million. In the other two cases, the outcomes were unknown. In conclusion, less than one-half of 1% of the 1,071 cases involved successful litigation of auditors for going concern issues.

An examination of articles regarding auditor litigation revealed few instances of litigation for going concern issues. Carcello and Palmrose, in "Auditor Litigation and Modified Reporting on Bankrupt Clients" [*Journal of Accounting Research* 32 (Supplement) 1994], found that out of 655 public companies that went bankrupt between 1972 and 1992 and were audited by "Big" firms, 83 received going concern opinions on their last financial statement before bankruptcy or litigation. Of the 83 companies that received going concern opinions, only five were the subject of auditor litigation. Carcello and Palmrose do not provide specifics or the outcomes of the cases.

According to the SEC, the Private

Securities Litigation Reform Act of 1995 makes it "more difficult ... for private plaintiffs to assert civil claims against auditors," allowing auditors to have even less concern for the risk of litigation. In fact, in "Going-Concern Opinions in the 'New' Legal Environment" [*Accounting Horizons*, 16(1) 2002], Geiger and Raghunandan found that auditors were more than twice as likely to issue a going concern opinion before the 1995 reform act was passed as after. Exhibit 2 shows that 9.5% of companies in the sample received a going concern opinion before the reform act was passed, while only 3.5% of companies received one after. Geiger and Raghunandan concluded that the reform act relieved auditors' concern for exposure to litigation and has led auditors to issue fewer going concern opinions. The results of this study, combined with the low number of cases of auditor litigation for going concern issues, has led the authors to believe that litigation in this area is not a serious threat to practitioners.

Prediction Models

Bankruptcy and going concern prediction have been researched for decades. An increased interest in prediction models began with the development of Beaver's univariate model in 1966 and Altman's multivariate discriminant analysis model in 1968.

The authors found more than 50 models available for bankruptcy or going concern prediction. The models employ various methodologies, including multivariate discriminant analysis, logit analysis, probit analysis, neural networks, and hybrid systems. The number of factors considered ranges from two to 32 items. These prediction models could help auditors anticipate financial

problems and going concern issues earlier. Many of these models have demonstrated predictive ability as high as 90% to 100% in classifying bankrupt (or going concern) and nonbankrupt (or non-going concern) companies.

So why are these models not being used? One reason might be a basic lack of awareness of the models or of their predictive ability. Perhaps if the models received more exposure they would be more widely used. Another explanation could be resistance to change. The authors found that auditors do not desire additional guidance in the area of going concern, which implies that they are satisfied with current standards. Furthermore, auditors believe that going concern assessment is an area requiring significant subjective judgment. As such, they believe that the use of prediction models would remove professional judgment from the consideration of going concern.

The apparent lack of use of the models could also be attributed to auditors' worries that a qualified going concern opinion can become a self-fulfilling prophecy. Auditors may be reluctant to use a model that may indicate the need to issue a going concern opinion due to fear that such an opinion will preclude the client from obtaining financing required to turn around the company's financial situation. [See K. Menon and K. Schwartz, "The Auditor's Report for Companies Facing Bankruptcy," *Journal of Commercial Bank Lending*, 68 (5) 1986.] In addition, companies are likely to pressure their auditor to not issue a going concern opinion, placing the auditor in the difficult position of trying to keep the client happy while protecting the public interest.

Another reason could be that the models make heavy use of ratios and, according to interviews conducted by Mutchler: "[A]uditors by and large [do] not like ratio analysis." The auditors that Mutchler interviewed thought that their "insider" access to the company provided far more information than ratio analysis could provide.

Richard Morris, in "Forecasting Bankruptcy: How Useful Are Failure Prediction Models?" [*Management Accounting*, 76 (5) 1998], provided several other reasons for prediction models' disuse despite their apparent predictive abilities. Morris stated that the widespread use of such models would cause their use-

EXHIBIT 2
Results of Geiger and Raghunandan Study (2002)

	1992-1993 (Before Reform Act)	1996-1997 (Transition Period)	1999-2000 (After Reform Act)
Number of companies in sample	662	574	635
Percentage that received a going concern opinion	9.5%	5.5%	3.5%

fulness to quickly vanish because as more people use the models they would cease to provide an advantage. He also pointed out that most models are developed by considering data from a variety of industries, which can influence the results because not all industries behave in a similar manner; "normal" ratios can vary dramatically across industries. Furthermore, the data are drawn from a number of years, and average performance can change over time.

Although auditors could use a prediction model to justify the going concern opinion to the client or in court, the use of a model could make it more difficult to justify not issuing a going concern opinion. M. Jennings, D. Kneer, and P. Reckers, in "The Significance of Audit Decision Aids and Precise Jurists' Attitudes on Perceptions of Audit Firm Culpability and Liability" [*Contemporary Accounting Research*, 9 (2) 1993] suggest that practitioners are reluctant to use decisions aids

By issuing a going concern opinion, auditors are interjecting themselves into the decision-making process.

(such as prediction models) because outside parties may view these tools as having the same effect as standards and penalize auditors for wavering from the guidance provided by a model. Lowe et al. corroborate this suggestion, stating that "if firms develop and use decision aids, then they may be constrained to adhere fully to the decision aids' recommendations, as these aids may serve as implied standards of performance in future litigation." As discussed above, there is not a high risk of

litigation against the practitioner for either the issuance or nonissuance of a going concern opinion.

In summary, with a low risk of litigation, and potential increased accountability from the use of a nonrequired prediction model, why would the auditor choose to do so?

Cohen Commission Recommendations

In 1978, the Commission on Auditors' Responsibilities (Cohen Commission) provided recommendations for improving and specifying the responsibilities of independent auditors. One area in which changes were recommended was reporting on uncertainties, including going concern uncertainties. The Cohen Commission recommended eliminating from the audit report the "subject to" qualification relating to uncertainties. In 1988, the AICPA implemented this recommendation by no longer requiring use of a "subject to" qualified opinion to indicate substantial doubt about the entity's going concern status. As mentioned above, SAS 59 now requires a modified audit report with an explanatory paragraph regarding the going concern status.

The Cohen Commission further suggested the following:

If uncertainty about a company's ability to continue operations is adequately disclosed in its financial statements, the auditor should not be required to call attention to that uncertainty in his report. ... If the auditor does not believe disclosure is sufficient to portray the company's financial position, he should modify his opinion because the financial statements do not present the company's financial position in conformity with generally accepted accounting principles.

If this recommendation were implemented, the audit report would address the going concern issue only if the situation is not disclosed adequately in the financial statements. If the financial statement disclosures were complete, there would be no change to the audit report with regard to going concern.

Recommendations

The authors believe that the Cohen Commission's recommendations should be revisited and the going concern opin-

ion should be eliminated. The auditor's job is to assess whether the financial statements are presented in accordance with GAAP, not to judge the financial condition of the company. Statement of Financial Accounting Concepts (SFAC) 1, paragraph 33, states that one objective of financial reporting is to provide useful information for decision making. However, it goes on to state that "it is not a function of financial reporting to try to determine or influence the outcomes of those decisions. The role of financial reporting requires it to provide even-handed, neutral, or unbiased information." By issuing a going concern opinion, auditors are interjecting themselves into the decision-making process. If the financial statements are prepared in accordance with GAAP and provide useful information, the reader should be able to assess the company's financial condition.

The authors further believe that the going concern opinion does not provide useful information, and therefore does not meet the objective of SFAC 1. Often, market signals already indicate a possible impending failure, making the going concern opinion a lagging indicator. This situation is even more enhanced by today's technology and the ability to acquire information instantaneously via the Internet. The authors also consider the timeframe for the consideration of going concern too short to be useful. Many companies may appear to be "failing" in the near term of one year, but bankruptcy may take much longer or the company may turn around and avoid bankruptcy.

After weighing the above factors and the evidence that the going concern opinion lacks informative value, the authors ask: Why do auditors need to modify the audit report for going concern? Considering that litigation is not a serious threat, one can see that eliminating the going concern opinion is the favorable option. □

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