Going Concern Reporting Presentation to PCAOB's SAG November 9, 2011

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Overall Focus of Research Team

- Trends in going-concern (GC) audit opinions:
  - Changes over time and regulatory / legal regimes.
- Bankruptcy is usual proxy for “not a going concern” in auditing research.
- Bankruptcy prediction using financial and other data.
- Correlation between bankruptcies and GC audit opinions:
  - Bankruptcies without prior GC audit opinions.
  - Subsequent status of firms with GC audit opinions.
- Auditor and client factors associated with GC opinions.
- International differences in GC reporting.
- “Substantial Doubt”

Bankruptcies & GC Opinions

- Bankruptcies with some financial stress (i.e., not sudden/strategic bankruptcies) but without prior GC audit opinions: 30 to 60% in most studies examining various periods from 1970 to 2009.
- SAS No. 59 did not significantly change this proportion.
- Rate of bankruptcies without prior GC:
  - *increased* after 1995 (Reform Act) and 1998 (Uniform Standards Act).
  - *decreased* after Enron/SOX, but only temporarily.
  - 2000-2001 -- 47%
  - 2002-2003 -- 28%
  - 2004-2005 -- 41%
  - 2006-2007 -- 49%

GC Opinions: Rates and Consequences

- For companies with a first-time GC opinion, only about 10 percent enter bankruptcy within one year; proportion increases to 20-25 percent over 2-3 years.
- But about a third of GC opinion firms merge/are acquired within the next five years.
- Self fulfilling prophecy? U.S. evidence: GC opinion increases likelihood of bankruptcy, after controlling for financial stress.
- Negative market reaction to *unexpected* GC opinions.
- GC opinion leads to shift in investors' focus from income statement to balance sheet (GC opinion warns about high book values relative to liquidation value).

Determinants of GC opinions

- Auditor decision to modify for GC is a two-step process:
  - Identification of potential GC issue
  - Whether to issue a GC opinion
- Factors are associated with increased likelihood of GC opinions for stressed firms: Liquidity (-), Profitability (-), Leverage (+), Size (-), Prior GC opinion (+), Market returns (-), Defaults (+), Audit firm size (+), Audit report lag (+)
- Default status is most important variable.
- Factors associated with auditor independence may also impact the decision of the auditor to issue a GC modification.

“Substantial Doubt”

- Substantial doubt (SD) about the ability of the entity to continue as a going-concern
- What is substantial doubt?
- Mean (median) numerical threshold values (from 1994 study):
  - Audit partners/managers (n=45) 0.57 (0.51)
  - Bank loan officers (n=95) 0.72 (0.75)
  - Financial analysts (n=88) 0.71 (0.70)
  - District / superior court judges (n=32) 0.33 (0.30)
  - Congressional staff (n=2) 0.33
- Possible “Communication Gap”?
- Flexibility in audit opinion wording? (not mandate exact phrase, or permit conditional GC opinion --“if xxx, then SD about GC”)?
- More informative, but increases pressure from clients.