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Going-Concern Audit Report Recipients Before And After SAS No. 59

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Reporting and auditing requirements under SAS No. 59, which address the auditor's consideration of an entity's ability to continue as a going concern, require an explicit evaluation of a company's continued viability in every audit. For cases where such viability is in substantial doubt, a modified (but unqualified) report is to be rendered with an additional fourth paragraph describing the uncertainty about the entity's ability to continue in existence for the ensuing fiscal year.

It has been suggested that SAS No. 59, one of the profession's "expectations gap" standards issued in 1988, increased auditors' responsibility vis-a-vis going concern. Since SAS No. 59 was issued as an expectations gap standard to better serve financial statement users and to demonstrate the Auditing Standard Board's belief that auditors can and should take more responsibility for assessing the ability of their clients to continue as going concerns, one view is that SAS No. 59 would have increased auditors' propensity to issue going-concern modified reports. However, others have suggested that SAS No. 59 only codified existing practice since auditors were already assessing client viability in every audit and that it

has had little impact other than to increase documentation requirements of auditors. Such a view suggests that there would be no significant changes in auditors' decision making with respect to going concern reporting after SAS No. 59. Additionally, under SAS No. 59, an auditor must issue a going-concern modified opinion if there is "substantial doubt" about the ability of an entity to continue as a going concern. "Substantial doubt," however, is a subjective phrase that has not been specifically defined or quantified in the literature.

Financial statement users, however, have consistently expected auditors to render early warning signals, regardless of professional standards, under the premise that auditors are in the best position to determine when companies are in a situation of potential failure and report this doubt to interested parties. In fact, such perceptions have prompted numerous congressional hearings and have been reflected in the Private Securities Litigation Reform Act of 1995 which has an audit requirement section related to going-concern reporting. Specifically, the Act requires that

"Each audit . . . of the financial statements of an issuer by an independent

public accountant shall include, in accordance with generally accepted auditing standards, as may be modified or supplemented from time to time by the Commission [SEC] . . . an evaluation of whether there is substantial doubt about the ability of the issuer to continue as a going concern during the ensuing fiscal year" (Sec. 301 p. 762).

Along with this newly enacted securities legislation which essentially enacts SAS No. 59 into law for publicly traded companies, comes the need to evaluate whether the requirements under SAS No. 59 have had any significant effect on auditor reporting decisions.

The Study

In an attempt to provide information to make such an evaluation, a study was conducted that examined companies receiving going-concern modified reports before and after the implementation of SAS No. 59. We wanted to assess whether auditors were issuing going-concern modified reports to clients exhibiting different levels of financial stress and also whether the bankruptcy rate of such companies was different after the adoption of SAS No. 59. While prior

studies have found that the proportion of bankrupt companies receiving going-concern modified reports just before entering bankruptcy rose from 40–45% before SAS No. 59 and around 60% right after SAS No. 59, little evaluation has been made regarding the status of companies receiving going-concern modified reports before and after SAS No. 59.

To examine these issues, companies receiving first-time going-concern modified audit reports were examined. The *Compact Disclosure (CD) SEC* database was searched for all manufacturing firms (SIC 2000 to 3999) receiving going-concern reports for two years before and two years after the implementation of SAS No. 59. Since SAS No. 59 was effective for fiscal year ends on or after December 31, 1989, data from 1990 and 1991 financial statements were used for the post-SAS No. 59 period. Since auditors could have adopted SAS No. 59 early and used it during 1989, we excluded audit opinions issued during the year 1989. Consequently, we used data from 1987 and 1988 financial statements for the pre-SAS No. 59 period.

The average bankruptcy probability estimates from a bankruptcy prediction model were then compared for the pre- and post-SAS No. 59 periods to ascertain if auditors were rendering going-concern modified opinions under SAS No. 59 to similarly financially stressed companies.

The following sources were used to establish the subsequent viability status for our sample companies: (1) Wall Street Journal Index, (2) Compact-Disclosure, (3) Predicast's Index of Corporate Change, (4) New Generation Research's Database of Bankrupt/Distressed Securities, and (5) the Bloomberg Financial Markets Database. Only firms for which subsequent financial statements could be found, and not in bankruptcy, were designated as non-failed firms. The data requirement resulted in 173 (236) useable companies in the pre-(post-) SAS No. 59 periods for a total of 409 companies. If we restrict our sample to companies with two years of available data, we get 135 (218) useable firms in the pre-(post-) SAS No. 59 period for a total of 353 companies.

Study Results

The overall results are presented in Table 1. The mean probability of bankruptcy for the pre-SAS No. 59 period was .673, while the mean probability of bankruptcy for the SAS No. 59 period was .718. The difference

	PROBABILITY OF BANKRUPTCY* MEAN	NUMBERS OF COMPANIES THAT FILED FOR BANKRUPTCY*	
		1 YEAR (N=409)	2-YEARS (N=353)
Pre-SAS No. 59	.673	17 (9.8%)	31 (23.0%)
Post-SAS No. 59	.718	32 (13.6%)	53 (24.3%)
Overall	.700	49 (12.0%)	84 (23.8%)

*Based on 173 pre-SAS No. 59 and 236 SAS No. 59 companies.

in bankruptcy probability between these two time periods is in the expected direction, it is not significant, indicating that auditors were not issuing going-concern modified opinions to differently stressed clients after the implementation of SAS No. 59.

This finding is consistent with the argument that, in general, auditors were already actively evaluating the going-concern status of clients before SAS No. 59. Thus, the adoption of SAS No. 59 appears to have only codified existing practice. In fact, the average probability of bankruptcy actually increased slightly for our sample after SAS No. 59 was implemented.

The results in Table 1 also indicate that roughly the same proportion of clients filed for bankruptcy before and after SAS No. 59 for both the one-year and two-year time horizons. While 12% of the companies filed for bankruptcy in the year following their initial going-concern report, approximately 24% filed for bankruptcy within two years.

These relatively low failure rates are indicative of an expected conservative reporting position regarding going-concern related uncertainties. With financial statement users looking to receive early warnings of potential failure, auditors would be expected to render going-concern opinions when issues of financial stress and questions of continuation begin to arise. However, certainly not all financially stressed companies fail within one or two years of their first-time going-concern modified opinion.

CONCLUSION

Coupled with earlier studies that have found increased proportions of bankrupt companies receiving a going-concern audit opinion immediately after the issuance of SAS No. 59, these findings of no significant differences in going-concern report recipients filing for bankruptcy are reassuring. Taken together, the studies indicate that overall auditor reporting after SAS No. 59 may have been improved. More bankrupt

companies have received modified reports, yet the same overall percentages of companies eventually failed after receiving a going-concern modified report. However, while these combined findings show net gains regarding reporting for going-concern uncertainties, they also indicate room for improvement.

SAS No. 59 requires auditors to look at client managements' plans, strategies, and ability to overcome any financial and business stress. Auditors must also assess existing circumstances and events within the client organization, as well as those of related companies, other companies in the industry, and the economy in general. Auditors must closely monitor all events that affect the client's financial viability—even prior to when significant levels of financial stress are reflected in the financial statements. These critical evaluations are essential to allow auditors to make an accurate assessment of the client's ability to continue, and thus enable accurate and timely reporting on continued viability.

As indicated in SAS No. 59, auditors are not responsible for predicting future conditions or events. Auditors' assessments of continued existence are constrained by the availability and accuracy of information. Auditors are, however, responsible for understanding and assessing existing conditions or trends that may lead to financial stress and eventual business cessation. Critical analyses and judgment play important roles in these required evaluations. A more skeptical or thorough approach to continued existence evaluations under SAS No. 59, and now the 1995 Act, would enable auditors to further increase their effectiveness in reporting on going concern.

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