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Going Concern Report Modeling: A Study of Factors Influencing the Auditor's Decision

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Much research has either examined which variables are pertinent to bankruptcy prediction or, alternatively, examined which models have greater ability to predict financial distress. The plethora of published research aims to help auditors in their decision to issue modified reports to clients facing financial distress that could threaten their long-term survival. Studies focusing on variables have selected key ratios from prior research. The predictive ability of models (logit, probit, discriminant analysis or neural networks, among others) is dependent on the variables used in those models for prediction. In this study we examine, during the period of 1996 to 2001, the variables that actually provided an impetus to auditors to issue the modified report in the presence of financial distress. These were obtained by reviewing the reasons cited in the explanatory paragraph of the modified auditor's report. A total of 576 modified audit reports were examined. The variables that were cited by auditors most frequently as the reason for modifying the report were substantial loss, recurring losses, working capital deficit, retained earnings deficit, difficulty in obtaining refinancing funds, negative cash flow from operations, debt default and debt covenant violation. We ran a logit regression and found these variables had significant explanatory power. We subsequently used these variables in a logit model to test predictive accuracy and obtained an accuracy rate of 98.68%. While the preponderance of published studies have examined predictive accuracy of models, we examine predictive accuracy of the variables that are the source of input in a model. The contribution of this paper is to identify variables with the most predictive power and develop a model that auditors can use in their decision to issue the modified report.

INTRODUCTION

The going concern assumption is fundamental to the preparation of financial statements in accordance with generally accepted accounting principles. If there is no evidence to the contrary, an entity is viewed as having the ability to continue in operation into the foreseeable future. When the continued existence of a firm is in question, the auditor is faced with