Louisiana Tech University
Louisiana Tech Digital Commons

Doctoral Dissertations Graduate School

Fall 1997

Does the going concern explanatory paragraph have information content as perceived by bank loan officers?

Rafik Zakaria Elias

Follow this and additional works at: https://digitalcommons.latech.edu/dissertations

Recommended Citation

Elias, Rafik Zakaria, "" (1997). *Dissertation*. 730.
https://digitalcommons.latech.edu/dissertations/730

This Dissertation is brought to you for free and open access by the Graduate School at Louisiana Tech Digital Commons. It has been accepted for inclusion in Doctoral Dissertations by an authorized administrator of Louisiana Tech Digital Commons. For more information, please contact digitalcommons@latech.edu.

INFORMATION TO USERS

This manuscript has been reproduced from the microfilm master. UMI films the text directly from the original or copy submitted. Thus, some thesis and dissertation copies are in typewriter face, while others may be from any type of computer printer.

The quality of this reproduction is dependent upon the quality of the copy submitted. Broken or indistinct print, colored or poor quality illustrations and photographs, print bleedthrough, substandard margins, and improper alignment can adversely affect reproduction.

In the unlikely event that the author did not send UMI a complete manuscript and there are missing pages, these will be noted. Also, if unauthorized copyright material had to be removed, a note will indicate the deletion.

Oversize materials (e.g., maps, drawings, charts) are reproduced by sectioning the original, beginning at the upper left-hand corner and continuing from left to right in equal sections with small overlaps. Each original is also photographed in one exposure and is included in reduced form at the back of the book.

Photographs included in the original manuscript have been reproduced xerographically in this copy. Higher quality 6" x 9" black and white photographic prints are available for any photographs or illustrations appearing in this copy for an additional charge. Contact UMI directly to order.

UMI

A Bell & Howell Information Company
300 North Zeeb Road, Ann Arbor MI 48106-1346 USA
313/761-4700 800/521-0600

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

DOES THE GOING CONCERN EXPLANATORY PARAGRAPH HAVE INFORMATION CONTENT AS PERCEIVED BY BANK LOAN OFFICERS?

by

Rafik Z. Elias, B.S., M.S., C.P.A.

A Dissertation Submitted in Partial Fulfillment
for the Degree
Doctor of Business Administration

LOUISIANA TECH UNIVERSITY
COLLEGE OF ADMINISTRATION AND BUSINESS

November 1997

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

UMI Number: 9812173

UMI Microform 9812173
Copyright 1998, by UMI Company. All rights reserved.

This microform edition is protected against unauthorized copying under Title 17, United States Code.

UMI
300 North Zeeb Road
Ann Arbor, MI 48103

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

LOUISIANA TECH UNIVERSITY

THE GRADUATE SCHOOL

November 20, 1997
Date

We hereby recommend that the dissertation prepared under our supervision

by Rafik Zakaria Elias

entitled Does the Going Concern Explanatory Paragraph Have Information Content as Perceived by Bank Loan Officers?

be accepted in partial fulfillment of the requirements for the Degree of

Doctor of Business Administration

Supervisor of Dissertation Research

Recommendation concurred in:

Advisory Committee

Approved:

Director of Graduate Studies

Dean of the College

Approved:

Dean of Graduate School

GS Form 13
8/96

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

ABSTRACT

Reporting going concern uncertainty has always been a controversial issue for standard-setters, auditors, and users of the financial statements. Current standards require the auditor to include an explanatory paragraph in an unqualified audit opinion to report going concern uncertainty. This research investigated the information content attributed to this additional paragraph as viewed by users.

Two groups of commercial loan officers were presented with the same information for an actual case company exhibiting going concern uncertainty. One group received a modified report and a footnote disclosure of the going concern situation while the other group received an unqualified report and the footnote disclosure. Both groups were asked to indicate the likelihood that a line of credit would be granted to this company, provide an estimate of the interest rate, indicate their confidence in their decision, and indicate their perception of this company's potential bankruptcy. A seven-point Likert scale was used.

Parametric and nonparametric tests were applied to the data. The results did not find both groups' answers on any of the Likert scales or the interest rate estimate to be statistically different based on a modified report

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

and a footnote disclosure compared to an unqualified report and a footnote disclosure. This study, therefore, showed that the explanatory paragraph for going concern uncertainty did not have information content. With the elimination of the explanatory paragraph requirement for other uncertainties, serious consideration should be given to eliminating this requirement for going concern uncertainty as well.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

TABLE OF CONTENTS

Page

ABSTRACT iii

LIST OF TABLES viii

AKNOWLEDGEMENTS ix

DEDICATION x

Chapter

1. INTRODUCTION 1

Importance of Studying the Going Concern Issue 2
Need for Additional Research on Going Concern 3
Purpose of the Study 5
Statement of the Problem 5
Research Design 6
Data and Sample Selection 7
The Experiment 7
Expected Contribution of the Study 7
Dissertation Outline 7

2. LITERATURE REVIEW 9

Early Efforts by the Auditing Profession 9
Commission on Auditors' Responsibilities 10
SAS No. 34 13
The Expectation Gap 13
SAS No. 58 15
SAS No. 59 16
SAS No. 79 19
Consequences of Qualified Opinions 20
Auditor Changes 21
Company Failures 23

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Other Consequences 24
Impact of SAS No. 59 27
Summary 29
Information Content Market Studies 33
Summary 40
Information Content Experimental Studies 44
Summary 52

3. RESEARCH METHODOLOGY 57

Theory and Hypotheses Development 57
Research Method 61
Experimental Design 61
Sample Selection 63
Case Company 64
Case Development 65
Questionnaire and Task 67
Statistical Tests 68
Parametric Tests 70
Equality of Means 70
Ordinary Least Squares 71
Nonparametric Tests 72
Summary 74

4. DATA COLLECTION, ANALYSIS, AND RESULTS 75

Data Collection Procedures 75
The Pilot Study 75
The Main Study 77
Test for Nonresponse Bias 79
Research Results 82
Hypotheses Tests 82
Summary 91
Ordinary Least Squares 91
Nonparametric Tests 102
Summary 104

5. DISCUSSION AND IMPLICATIONS OF FINDINGS 105

Discussion of Findings 105
Likelihood of Granting Credit 106
Interest Rate Estimate 108
Confidence in Lending Estimate 109
Bankruptcy Prediction 109

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Demographic Characteristics 110
Implications of Findings 110
Limitations of the Study 111
Suggestions for Future Research 112

APPENDIX A 113

APPENDIX B 122

APPENDIX C 124

REFERENCES 127

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

LIST OF TABLES

Table Page

2.1 Consequences of Qualified Opinions 30

2.2 Information Content Market Studies 41

2.3 Information Content Experimental Studies 53

4.1 Comparison of Early and Late Respondents 81

4.2 Comparison of Both Groups' Lending Estimate 84

4.3 Comparison of Both Groups' Interest Rate Estimate 86

4.4 Comparison of Both Groups' Confidence 88

4.5 Comparison of Both Groups' Bankruptcy Perception 90

4.6 Effect of Demographic Characteristics on the Lending Estimate 93

4.7 Effect of Demographic Characteristics on the Interest Rate 95

4.8 Effect of Demographic Characteristics on Bankers' Confidence 97

4.9 Effect of Demographic Characteristics on Bankruptcy Estimate 99

4.10 Effect of Bankruptcy Perception on the Interest Rate 101

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

ACKNOWLEDGMENTS

I express my appreciation to my dissertation committee for their help and support. My chairman, Dr. James Johnston, gave freely of his time and skillfully guided me through this project. His help is greatly appreciated. Dr. John Shaver advised me and supported me through the process. Dr. Tom Sale helped me with his banking experience. I was fortunate to have such a supportive committee. The editorial assistance of Dr. James R. Michael and Ms. Margaret Dunn is appreciated.

I also express my appreciation to all my fellow doctoral students in business at Louisiana Tech University. They showed comradeship, and came to my rescue in moments of trouble. They gave me a memorable experience that I will always cherish.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

DEDICATION

"God will put his angels in charge of you to protect you wherever you go" (Ps. 91:11). This work is dedicated first and foremost to Almighty God. His eternal love, grace, and mercy protect me all my life.

This dissertation is also dedicated to my parents. They constantly urged me to put forth my best effort and without their help, I would have never received a doctorate. It is especially dedicated to my father, the most important figure in my life, who always taught me to search for knowledge and that a good education was priceless.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

CHAPTER 1

INTRODUCTION

Financial statements of business enterprises must conform with prescribed standards known as Generally Accepted Accounting Principles (GAAP). GAAP consists of certain rules and assumptions. One important assumption--that of the going concern--has received considerable attention and caused much controversy in recent years. Under this assumption, a business enterprise will continue indefinitely, or at least long enough to fulfill its objectives. A violation of this assumption can have a serious impact on financial statements. For example, it justifies the depreciation of long-term assets. Disregard for this assumption would justify charging assets as expenses in the period acquired. The going concern assumption also justifies the classification of some assets and liabilities as long-term. Without the enterprise continuity assumption, the liquidation basis of accounting would be appropriate.

In addition to its importance in the formulation of GAAP, the going concern assumption bears crucially on audits. The auditor issues an opinion stating that the financial statements are "in conformity with Generally Accepted Accounting Principles." If preparers have not followed GAAP, the auditor must issue a qualified or adverse opinion. Therefore, the auditing profession has

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

focused its attention on the going concern issue. Past discussions of the going concern concept and the resulting standards have had two major objectives. They have sought to establish guidelines for the auditor in determining compliance with (or departure from) the going concern assumption, and they have attempted to determine the best way for communicating non-compliance information to users.

Importance of Studying the Going Concern Issue

The going concern issue affects several parties: the companies, auditor(s), and users of the financial statements. Companies care about their financial health and their continuity, as well as their image in the industry and the potential negative impact of a deteriorating financial situation. Auditors have responsibilities to users who rely upon their reports. Users should only depend upon auditors to assure them that financial statements have been prepared in accordance with GAAP.

Users of the financial statements, especially investors and creditors, have critical interests in each company's viability for investment. The going concern assumption underlies the calculation of the required rate of return on investment during a particular period of time. Creditors, such as bankers, also have an interest in the company's continuity and its ability to repay loans and interest. Even though creditors have a priority in case of bankruptcy, they must consider the opportunity cost of making a loan to another company. Therefore,

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

during the audit, the auditor must consider the going concern issue and its possible implications on all parties involved.

Need for Additional Research on Going Concern

In 1988, the Auditing Standards Board (ASB) issued Statement of Auditing Standards (SAS) No. 59: "The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern." The ASB's chairman described this standard as "the most controversial of the numerous projects on which the ASB worked during 1986 to 1988" (Guy and Sullivan 1988, 43). The controversy arose because many companies had experienced bankruptcy shortly after receiving an unqualified opinion from their auditors. This created an expectation gap between users and auditors.

In an effort to address the expectation gap, SAS No. 59 required auditors to specifically consider the going concern issue in every audit. This standard imposed substantially more responsibility on the auditors than had its predecessor, SAS No. 34: "The Auditor's Considerations When a Question Arises about an Entity's Continued Existence." That standard had required auditors to consider going concern uncertainty only if they discovered contrary information during audits. In those cases, they would issue "subject to" qualified opinions. SAS No. 59 provided for the issuance of unqualified opinions, but still required that the auditor's report contain an explanatory paragraph describing the going concern doubt.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Substantially less research has examined the explanatory paragraph requirement than the "subject to" requirement. This lack of research has continued even though explanatory paragraphs arguably have retained certain "red flag" features (Kaplan and Pany 1992). In their study of comment letters on SAS No. 59's exposure draft, Kaplan and Pany found considerable user support for this standard. However, responses indicated a difference of opinion among "Big Six" firms as well as among smaller firms.

Empirical evidence concerning the frequency of issuing going concern opinions after SAS No. 59 showed the need for additional study. According to Carsello, Hermanson, and Huss (1995), auditors did not tend to issue going concern modified reports after SAS No. 59 became effective. On the other hand, Raghunandan and Rama (1995) provided different results showing auditors issuing more modified reports after SAS No. 59 took effect. These conflicting results showed the need for additional study of the impact of SAS No. 59 on interested parties.

Timing has also added importance to this study. During 1988, the ASB issued SAS No. 58: "Reports on Audited Financial Statements." This standard required each auditor to modify his report using an explanatory paragraph highlighting any uncertainties (other than going concern) facing the company. However, in December 1995, SAS No. 79 amended SAS No. 58, and it eliminated the explanatory paragraph requirement. SAS No. 79, however, did not amend SAS No. 59 regarding the use of an explanatory paragraph for a

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

going concern issue. The issuance of a special standard dealing with going concern uncertainty, as well as the refusal to change it later, indicated the importance of this problem and the method of reporting it.

Purpose of the Study

The primary purpose of this study has been to examine the usefulness of the explanatory paragraph concerning going concern uncertainty to users of the financial statements. The elimination of explanatory paragraphs for other uncertainties has created the need for a prescriptive study to determine the appropriate treatment of explanatory paragraphs for going concern uncertainties. This project selected financial statement users for its study group; the ASB had targeted them in its standard-setting process, and they had provided the most input to SAS No. 59's exposure draft.

Secondary objectives included gaining insight into users' reaction to financial statements of companies exhibiting going concern problems. The study also examined the impact of the explanatory paragraph on users' confidence and whether such a paragraph increased the perception of bankruptcy.

Statement of the Problem

The APB has mandated use of an explanatory paragraph (when applicable) for going concern uncertainty in audit reports. However, the accounting profession has not yet developed a consensus about the information

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

content of the explanatory paragraph. This study has addressed the problem of determining the information content of the explanatory paragraph. In particular, it has attempted to determine whether the explanatory paragraph has provided user information in addition to that not conveyed through footnote disclosures. This study has also sought to measure the "side effects" of the modified report on the lending decision, and it has attempted to determine whether going concern disclosures increased the perception of bankruptcy.

Research Design

In the interest of realism, the experiment for this study used Securities and Exchange Commission (SEC) Form 10-K report data from a company that actually received a going concern modified report.

Data and Sample Selection

The participant sample for this experiment consisted of loan officers in different banks across the United States. Those bankers had experience in reviewing loan applications from businesses similar to the company selected. The study utilized a mail questionnaire.

The Experiment

Data for this study included a selected company's financial statements, as well as the audit report and the footnote explaining going concern uncertainty. The participant sample was divided into two groups. The first group evaluated an unqualified audit report with the explanatory paragraph

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

(i.e., a "modified" report), as well as the footnote; the other group evaluated an unqualified audit report with no explanatory paragraph, as well as the footnote.

Each participant was asked to estimate the likelihood that his bank would grant a specified line of credit, as well as what interest rate the bank would charge. The study attributed risk perception differences--between groups, but for the same company--to the information content of the explanatory paragraph.

Expected Contribution of the Study

This study has investigated some possible effects of eliminating the explanatory paragraph requirement for reporting going concern uncertainty. For other uncertainties, the APB had reasoned that footnote disclosures provided a sufficient explanation that made the explanatory paragraph unnecessary. This prescriptive research should shed light on the usefullness of an explanatory paragraph regarding going concern uncertainties by focusing on an important segment of audit report users. Also, it should shed light on bankers' perception of going concern uncertainty.

Dissertation Outline

Following this introduction, Chapter 2 presents a literature review detailing the profession's struggle with the going concern problem and the appropriate method for reporting it. It reviews several studies explaining the consequences of going concern warnings, as well as studies of capital markets

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

and studies investigating the information content of these warnings. Chapter 3 describes the research methodology, sample selection, and data gathering techniques employed in this study. Chapter 4 presents analyses of the data obtained from the experiment. Chapter 5 discusses the findings and their policy implications. The Appendices present the case, the questionnaire and a sample of respondents' comments.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

CHAPTER 2

LITERATURE REVIEW

This chapter presents a review of the auditing profession's attempt to deal with the going concern issue through commissions and standards. It initially examines early efforts that dealt with the issue of uncertainties in general (such as SAP Nos. 15 and 33 and SAS Nos. 58 and 79), and going concern uncertainties in particular (such as SAS Nos. 34 and 59). It then reviews empirical studies examining the consequences of qualified opinions on companies and auditors. The next section reviews capital market studies dealing with the information content of qualified opinions, especially those qualified due to uncertainties and going concern issues. That section examines studies using pre- and post-SAS No. 59 language. The final part of this chapter reviews experimental studies that have examined the information content of qualified opinions and reports modified due to uncertainties.

Early Efforts by the Auditing Profession

Statement on Auditing Procedure (SAP) No. 15 (in 1942) addressed the effect of uncertainties in general, including going concern uncertainty, on the audit report. The statement suggested that the cumulative effect of

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

uncertainties could require modification of the standard audit report and could make the auditor unable to render an opinion. SAP No. 33 (in 1963) required that audit reports modified due to material uncertainties--including going concern uncertainty--contain the qualifying words "subject to."

Commission on Auditors' Responsibilities

The requirement to issue a "subject to" opinion triggered debate and controversy on the appropriate way to report uncertainties. In 1974, the Commission on Auditors' Responsibilities (CAR)--also known as the Cohen Commission--was formed to determine the appropriate level of auditors' responsibilities regarding uncertainties. In 1978, the CAR recommended elimination of "subject to" opinions. The commission had deemed these opinions deficient in several respects. First, the commission believed that SAP No. 33 unreasonably required the auditor to serve as a reporter and interpreter of financial information when reporting on uncertainties. In addition, the auditor was in no better position than users to predict the outcome of the uncertainty. Second, the "subject to" opinion may have confused users by creating the false impression that preparers would restate the financial statements upon resolution of the uncertainty. Third, the commission believed that SAP No. 33 may have created false expectations that unqualified opinions meant no uncertainties. In the Commission's view, "All companies, however, face a variety of economic risks." Fourth, the requirement to qualify could

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

cause the auditor to overlook the appropriateness of the footnote disclosure. The CAR recommended that the auditor not attempt to reduce uncertainty by predicting the outcome of future events. The Commission acknowledged users' needs for a warning signal, but it noted that users should not view going concern qualifications as a prediction of bankruptcy. The CAR also acknowledged the "self-fulfilling prophecy" feature of the going concern qualification when it noted, "Creditors often regard a 'subject to' qualification as a separate reason for not granting a loan." The CAR concluded overall that the auditor should appropriately disclose all uncertainties, including going concern issues, in the footnotes.

The Commission's recommendations regarding uncertainties faced strong opposition from users. Several studies sought to determine investors' and bankers' preference for reporting uncertainties.

Shank, Dillard, and Murdock (1978) presented senior loan officers with the option to choose the method through which auditors *should* communicate uncertainty and their perception of the way in which auditors *would* communicate. The options consisted of (1) no reference to the situation, (2) disclosure only in the unaudited section of the annual report, (3) disclosure in a footnote, (4) disclosure plus a "subject to" opinion, and (5) disclaimer of opinion. The officers reviewed eight cases involving contingencies, including going concern difficulties. Most officers indicated that for all contingencies the auditor should issue a qualified opinion. They had an even higher preference

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

for going concern uncertainty. Only 38% correctly predicted how the auditor would report the contingency. The bankers also noted that qualified opinions provided a better defense for the auditor in case of an unfavorably resolved contingency.

In another study, Shank, Dillard, and Bylinski (1979) surveyed investors to determine their reporting preferences regarding uncertainties. They presented eight cases and gave investors the following options: (1) no specific reference to the situation, (2) disclosure only in the unaudited section of the annual report, (3) disclosure in a footnote to the financial statements, (4) disclosure in the footnotes plus a "subject to" audit report, and (5) disclaimer of opinion. Similar to the bankers' study, investors expressed preference for the "subject to" audit report. Most investors noted that the auditor should report contingencies through a qualified opinion and a footnote disclosure, especially for going concern problems.

These studies indicated investor and banker opposition to the CAR's recommendation to eliminate the qualified opinion. Bankers argued that qualified opinions served useful purpose in decision making. The ASB considered the Committee's recommendation. In fact, the ASB came close to implementing it in 1982, with SEC concurrence. However, according to Asare (1990), in a public meeting to discuss the exposure draft, users voiced strong opposition that lawmakers later supported, and the ASB never implemented the standard.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

SAS No. 34

In 1981, the ASB issued SAS No. 34 dealing specifically with the going concern issue. The standard did not impose a responsibility on auditors to evaluate the company's going concern status unless they discovered contrary information during the audit. The auditor's responsibility did not extend beyond the consideration of asset recoverability and liability classification. If auditors had doubt about the entity's *continued existence*, the new standard required that they should consider mitigating factors and the effect of this doubt on the financial statements. SAS No. 34 required them to issue a qualified "subject to" opinion if they questioned the recoverability of assets and classification of liabilities.

The level of responsibility indicated by SAS No. 34 proved inadequate for lawmakers and users. They noted that many businesses (such as United American Bank and Penn Square Bank) had failed shortly after receiving an unqualified audit opinion. Because SAS No. 34 did not fulfill users' wishes, an expectation gap developed.

The Expectation Gap

Practitioners acknowledged an expectation gap but could develop no consensus supporting additional auditor responsibilities. Elliott and Jacobson (1987) argued that auditors could not provide an effective warning signal for bankruptcy because no one could. They argued

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

> The underlying question is not whether auditors should be providing early-warning information in audit reports but whether *users are receiving sufficient audited financial information* to assist them in reaching conclusions on the future prospects of business entities. (Emphasis added)

The authors implied limited auditor responsibility. Auditors should only present financial information to permit users to make decisions.

Campbell and Mutchler (1988) compared auditors' and bankers' perceptions of the going concern audit opinion. Auditors indicated that they issued a going concern opinion because of likely failure and that the value of the assets reported in the financial statement did not indicate recoverable value. Surprisingly, 39% of the auditors indicated the need for a going concern opinion in the event of probable failure. Additionally they thought the auditor should provide a signal to financial statement users. In interpreting these findings, the authors argued that many of the auditors responded with what they thought they should do.

Most bankers chose the option that auditors did have the responsibility for signaling going concern doubt. Both groups deemed the opinion important and useful. The authors concluded that the ASB could eliminate the expectation gap with no difficulty. These results prompted the ASB to consider issuing a statement that would satisfy users by retaining the early warning signal while eliminating the "subject to" qualification.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

SAS No. 58

In 1988, the Accounting Standards Board issued a number of "expectation gap standards." SAS No. 58 dealt with uncertainties in general, and SAS No. 59 dealt specifically with going concern uncertainty.

SAS No. 58 defined an uncertainty as

> A matter . . . that is expected to be resolved at a future date, at which time sufficient evidential matter concerning its outcome would be expected to become available.

For example, the auditors for a defendant in a lawsuit with an uncertain outcome on the balance sheet date would have to consider the adequacy of the footnote disclosure regarding this uncertainty. If the auditors considered the disclosure inadequate, they would have to add an explanatory paragraph to the unqualified opinion emphasizing the uncertainty and referring the user to the appropriate footnote. This type of opinion became known as "the modified report." The standard did not specify the language of the explanatory paragraph. Inadequate footnote disclosures would constitute a departure from GAAP, and require a qualified or adverse opinion.

SAS No. 58 effectively eliminated "subject to" opinions and replaced them with modified reports that retained the warning signals. It appeared that the ASB believed in the CAR's recommendation that the words "subject to" confused users. However, the ASB continued to require early warnings, and it shifted its emphasis to *how* to report uncertainties in the audit report, not

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

whether to report them. The ASB, therefore, partially implemented the Cohen Commission's recommendations.

The ASB felt that uncertainties fell into different categories. One category of uncertainties related to litigation and other situations involving losses, while a second, more serious, category related to going concern issues. The board clarified its apparent classification of uncertainties when it issued a special statement dealing with going concern uncertainties.

SAS No. 59

SAS No. 59, issued in 1988 and effective in 1989, substantially changed the way auditors considered and reported going concern problems. For example, SAS No. 59 specifically required the auditor to consider the going concern assumption in every audit. SAS No. 59 focused, not on the recoverability of assets or the classification of liabilities, but rather on the going concern assumption. SAS No. 59 imposed an affirmative duty on the auditor, compared to a negative duty under SAS No. 34. SAS No. 59 offered several guidelines for the auditor in dealing with the going concern issue. For example, the standard listed negative trends--such as working capital deficiencies and negative cash flows--as factors raising substantial doubt about the entity's ability to continue as a going concern. Other factors included internal matters (such as work stoppages or labor problems), significant need to revise operations, and external matters (such as legislation changes or losses of key franchises or patents).

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

If the auditor discovered such factors during the audit, it would justify doubt about the entity's going concern assumption. If there were substantial doubt about the entity's ability to continue as a going concern for a period not to exceed one year from the date of the financial statements, the auditor would have to consider management's plans to mitigate the problem. Management's plans may include disposition of assets, additional borrowing, and/or restructuring. In considering management's plans, the auditor would have to consider positive and negative factors in the implementation of these plans. Adequate management plans, along with complete disclosures, would make report modification unnecessary.

If, after reviewing management plans, there were still substantial doubt, the auditor would have to consider the completeness of the disclosures and could issue a modified report. That report would contain an explanatory paragraph, and an unqualified opinion, if appropriate. Incomplete and insufficient disclosures would constitute a departure from GAAP, and the auditor would issue a qualified or adverse opinion. The ASB left most of the language of the explanatory paragraph to the auditor's discretion. The ASB required that the auditor would mention the condition(s) giving rise to substantial doubt and would refer the reader to the appropriate footnote. The standard also required the use of the phrase "substantial doubt about its (the entity's) ability to continue as a going concern."

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

SAS No. 59, however, allowed the auditor to issue either a modified report or a disclaimer of opinion. The standard did not provide the auditor with specific guidance in choosing the type of report. LaSalle, Anandarajan and Miller (1996) examined some of the factors that influenced the auditor in determining the type of report to issue. They surveyed 183 partners in CPA firms. Modified reports were sent to 130 partners and disclaimers of opinion were sent to 53 partners. The questions presented the partners with 51 items representing good news and bad news about a company and potential legal liability. The respondents were asked to assess the extent to which each factor was present in a client of their choice that received a going concern report. This survey, therefore, provided confidential information about 183 companies experiencing going concern difficulty. The respondents' perception of the importance of each factor in deciding which report to issue was measured on a 1 to 5 scale. The results showed that companies that received a disclaimer of opinion were more likely to have more bad news items, fewer good news items and weaker internal control. The results also showed that auditors who believed the going concern audit report offered protection from lawsuits were more likely to issue a disclaimer of opinion if the probability of a lawsuit was high.

In an attempt to analyze SAS No. 59, Ellingsen, Pany, and Fagan (1989) noted that although the standard required the auditors to evaluate going concern, they had no responsibility for predicting future events. They

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

compared an audit to an annual physical examination, whereby the doctor dealt with existing conditions as of the date of the examination and not with subsequent conditions. The doctor in this case had no responsibility for future events, and the patient could not hold the doctor accountable for such events.

In issuing SAS No. 59, the ASB implemented some of the CAR's recommendation. The ASB considered "subject to" opinions misleading and eliminated them. On the other hand, the board did not believe the CAR's recommendation that auditors could not assess viability as a going concern. Therefore, it retained the warning signal previously conveyed by "subject to" opinions by adding the explanatory paragraph. The standard focused on *how* to communicate going concern uncertainties, not on *whether* to communicate them.

The issuance of SAS Nos. 58 and 59 was an attempt to close the expectation gap by requiring auditors to communicate uncertainties to users to help them in their decision making. However, the question of report redundancy resurfaced during attempts to measure appropriate ways of communicating these uncertainties.

SAS No. 79

In December 1995, the ASB issued SAS No. 79: "Amendment to Statement on Auditing Standards No. 58, 'Reports on Audited Financial Statements.'" SAS No. 79 no longer required the auditor to use an explanatory paragraph to report certain uncertainties. Under the new standard, auditors

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

had the option of including an explanatory paragraph if they desired to do so. However, SAS No. 79 did not affect going concern reporting. It still required an explanatory paragraph for going concern uncertainties.

Birdzell (1996) analyzed the reasons for amending SAS No. 58. He noted that many users believed that the uncertainties paragraph communicated information not disclosed in the footnotes. Contrary to the ASB's intention, some users viewed the absence of the explanatory paragraph as indicating no uncertainties, and this impression discouraged them from reading the footnotes. The standards board noted that users required explanatory paragraphs based on concerns about the adequacy of footnote disclosures. Statement of Position (SOP) 94-6: "Disclosure of Certain Significant Risks and Uncertainties" required additional disclosures in the footnotes. This addressed users' concerns about disclosure adequacy, and it rendered the explanatory paragraph no longer necessary.

By issuing SAS No. 79, the ASB implemented another recommendation of the CAR. The board believed that explanatory paragraphs, for most uncertainties, contained no information beyond that in the footnotes, and that auditors should avoid them. The board, however, did not hold the same belief for going concern uncertainties.

Consequences of Qualified Opinions

Several studies have investigated the different consequences of qualified reports, especially those qualified or modified for uncertainties. The decision

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

to issue a qualified opinion certainly involved extensive discussion between the auditors and the company due to the potential signaling effect of this opinion. Such signaling may have induced auditor switching and the potential self-fulfilling prophecy effect. From the auditors' perspective, qualified opinions may have provided liability protection in case of a lawsuit. This section reviews related research in this area.

Auditor Changes

Chow and Rice (1982) provided early evidence that companies tended to switch auditors after receiving qualified opinions. They examined a total of 10,000 firms for the years 1973 and 1974. They classified firms into four categories: (1) those companies changing auditors after receiving a qualified opinion, (2) those companies keeping the same auditors after receiving a qualified opinion, (3) those companies changing auditors after receiving a clean opinion, and (4) those keeping the same auditors after receiving a clean opinion. Comparison tests indicated that companies tended to change auditors more frequently after receiving a qualified opinion. This result remained true after controlling for other factors leading to auditor changes. The authors also found that auditors differed in their tendency to issue qualified opinions.

In a similar study, Schwartz and Menon (1985) found no evidence of auditor switching. They examined a sample of only 131 failed firms, but they tested a larger time frame, from 1974 to 1982. They selected a control group by matching every bankrupt company with a non-bankrupt company in the

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

same industry. The study classified distressed companies that made auditor changes in the three-year period before bankruptcy as "switchers" and those that did not switch during the same period as "non-switchers." Comparison tests indicated no evidence of auditor switching after receiving qualified opinions.

Craswell (1988) examined the issue of qualified opinions and auditor switching in Australia. He reviewed about 33,000 annual reports of companies listed on the Sydney Stock Exchange from 1950 to 1979. Craswell considered only first-time qualifications, and he identified changes of auditors as those occurring any time within five years after the qualification. This time frame was differed from the one-year time frames used by Chow and Rice (1982) and Schwartz and Menon (1985). Craswell established two qualification classifications. "Serious" qualifications consisted of disclaimers, adverse opinions, and multiple reasons for qualification. "Minor" qualifications concerned technical accounting differences. His results indicated that companies tended to change auditors more frequently after receiving qualifications, especially "serious" qualifications.

The previous studies provided mixed results. However, use of different methodologies preclude direct comparisons of results. For example, the time frame used by Chow and Rice (1982) and Schwartz and Menon (1985) differed from the one used by Craswell (1988). Difficulties arose in attempts to compare Chow and Rice (1982) with Schwartz and Menon (1985) because the latter study used only failed firms and a different time period. In addition,

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Craswell examined only Australian firms. Therefore, the evidence on auditor switching after qualified opinions is inconclusive.

Company Failures

Williams (1984) interviewed 15 partners in large accounting firms about their impressions of the going concern opinion and its consequences. The partners indicated that they considered several factors when issuing a going concern opinion. The interviewers also sought opinions about the self-fulfilling prophecy of the going concern opinion. This prophecy stipulates that if the audit report refers to the going concern uncertainty, this referral, by itself, rather than the company's actual condition will cause the company to fail. The partners had different opinions about the self-fulfilling prophecy, but most of them said it did not affect their decision. Those partners rejecting the self-fulfilling prophecy noted that investors had enough sophistication to rely on additional sources.

Garsombke and Choi (1992) examined the association between uncertainty reporting and company failures in the 1981 to 1985 time period. Their sample consisted of surviving firms receiving clean opinions, "subject to" going concern qualifications, and going concern disclaimers. They matched and compared those firms with failed firms in order to determine the failure rates of firms with differing audit opinions. The results indicated that (1) firms with "subject to" going concern opinions had *higher* failure rates than firms receiving going concern disclaimers, and (2) firms with "subject to" going concern

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

opinions had *higher* failure rates than firms with clean opinions. These results indicated that going concern opinions had information content in predicting bankruptcy.

Louwers, Messina, and Richard (1996) also investigated the self-fulfilling prophecy of going concern opinions by examining the aftermath of 231 first-time going concern modifications on the clients' subsequent existence. They studied the 1984 to 1991 time period. The results showed that a significantly high percentage of firms survived their first time going concern qualifications. The authors concluded that these warnings had little importance in determining clients' survival.

These two empirical studies provided mixed evidence on the self-fulfilling prophecy and revealed a controversy that first appeared in Williams (1984). Garsombke and Choi (1992) supported the self-fulfilling prophecy; Louwers, Messina, and Richard (1996) did not. Different methodologies and different time periods mitigated against direct result comparisons.

Other Consequences

In many instances, qualified opinions had an impact on auditor switching, the self-fulfilling prophecy, and other less-researched consequences. Whittred (1980) examined audit report issuance delays in Australia due to report modifications. He classified modified reports into three groups: (1)qualified opinions, (2) adverse opinions, and (3) disclaimers. His study sample addressed first time modifications only. He identified a ten-year test

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

period (1965-74), and he tested the delay over two periods (between year-end and report date, and between report date and filing with the Sydney Stock Exchange). The results indicated the following: (1) that first time modifications delayed the release of audit reports and annual reports, and (2) that more serious modifications resulted in longer delays. Whittred attributed the delays to increased negotiation between the auditors and management in light of negative impacts. Elliott (1982) found similar results in the U.S.

Holt and Moizer (1990) investigated the meaning of different audit reports to auditors and users in the U.K. Users included bankers and stockbrokers. The audit reports ranged from unqualified opinions to scope limitations to going concern qualifications. Participants answered 13 questions about matters ranging from reliability and usefulness of financial statements to responsibility of auditors. The results indicated that, for going concern uncertainties, and for all 13 dimensions, users felt generally less confident about the financial statements than did the auditors. The authors concluded that auditors should understand the increased uncertainty caused by this report type.

Abbott (1994) interviewed audit managers and partners in large CPA firms regarding their impression of the going concern opinion. The subjects mentioned that SAS No. 59 and the litigation environment increased the CPA firms' documentation requirements, and those factors increased the number of partners involved in the audit. However, the partners and managers noted that

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

adding an explanatory paragraph did not protect the auditor from a lawsuit, despite the intentions behind SAS No. 59.

Carsello and Palmrose (1994) investigated lawsuit protection related to bankruptcy caused by allegedly inadequate warning signals. Their sample consisted of 655 public companies that declared bankruptcy between 1972 and 1992. They compared audit reports before bankruptcy among three groups of firms: (1) those with auditor litigation, (2) those with other litigation, and (3) those with no litigation. The results showed relatively greater numbers of modified audit reports for companies with no litigation; additionally, the results showed that lawsuits for companies receiving modified reports had the highest dismissal rate and the lowest payments in cases of adverse lawsuit outcome. The authors concluded that modified audit reports tended to weaken plaintiffs' claims against auditors.

The previous three experimental studies revealed several consequences of qualified and modified reports, especially those due to going concern problems. For example, qualified opinions caused delays in releases of audit reports. Qualified opinions also tended to reduce users' confidence in the financial statements. Empirical evidence showed modified reports due to going concern uncertainty protected auditors from lawsuits even though practitioners did not agree with this viewpoint.

Citron and Taffler (1992) investigated several consequences of qualified opinions in the U.K. During the period 1977 to 1986, only 26% of failing

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

companies received qualified opinions before bankruptcy. The results revealed a relationship between the likelihood of a company's failure and the probability of going concern modification. The results also showed that companies with a going concern qualification exhibited a significantly higher rate of auditor switching and that most of the companies receiving going concern modifications survived. The auditor switching results agreed with Chow and Rice's (1982) results, but the survival results differed from those of Garsombke and Choi (1992).

Impact of SAS No. 59

Several studies attempted to isolate the effect of SAS No. 59 on auditors propensity to issue going concern modified reports. For example, many studies attempted to determine whether SAS No. 59 caused auditors to evaluate going concern issues more thoroughly and issue modified reports in more audits. Other studies investigated whether more bankrupt companies had received going concern opinions.

Johnson and Khurana (1995) selected a sample of 185 companies filing bankruptcy between 1986 and 1992. The sample excluded companies with fiscal years ending during the transition period between SAS No. 59 issuance (1988) and the effective date (January 1, 1989). Comparison of the number of filings during the time periods under SAS No. 34 and SAS No. 59 revealed that a larger proportion of bankrupt companies had received modified reports after SAS No. 59 became effective. This result indicated success for SAS No. 59.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Raghunandan and Rama (1995) examined a sample of financially stressed firms to determine whether auditors had a greater propensity to issue going concern modified reports after SAS No. 59 became effective. They also examined a sample of bankrupt companies to determine if more of these companies received going concern opinions after the effective date of SAS No. 59. The results indicated a greater incidence of such reports to stressed companies after SAS No. 59. Raghunandan and Rama also found that bankrupct companies were more likely to have received modified reports after SAS No. 59 became effective.

Employing a design similar to that of Raghunandan and Rama (1995), Carsello, Hermanson, and Huss (1995) tested the hypothesis that auditors in Big Six firms issued more going concern reports to bankrupt companies after SAS No. 59. They examined a sample of 250 companies and found that auditors were not more likely to issue such reports to bankrupt clients. The two previous studies treated the transition period from SAS No. 34 to SAS No. 59 differently where the latter excluded it from the study while the former included it. Carsello, Hermanson and Huss (1997) reconciled these two studies by indicating that the treatment of this transition period substantially affected the results. The authors noted that there was no correct way of treating this period and therefore more research was needed with larger windows to reach more concrete conclusions.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Summary

The empirical studies reviewed in this section have indicated that issuing qualified opinions could have negative consequences, such as auditor switching and the self-fulfilling prophecy, as well and positive consequences, such as protection from lawsuits and early warnings. Table 2.1 summarizes results of those studies.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

TABLE 2.1

CONSEQUENCES OF QUALIFIED OPINIONS

Author(s) and Year of Study	Purpose of Research	Summary of Findings
Whittred (1980)	Delay of audit reports due to qualifications.	Audit reports delayed due to qualifications; Longer delays for more serious qualifications.
Chow and Rice (1982)	Propensity of companies to switch auditors after qualifications.	More companies switched auditors after receiving qualified opinions, but they did not get clean opinions after the switch.
Williams (1984)	Audit partners' impression of the going concern opinion.	Partners split on whether going concern opinions constituted self-fulfilling prophecies.
Schwartz and Menon (1985)	Propensity of failing firms to switch auditors after qualifications.	No evidence of auditor switching for failing firms.
Craswell (1988)	Auditor switching for failing firms after qualifications in Australia.	More failing firms switched auditors after qualifications, with new auditors giving clean opinions.
Holt and Moizer (1990)	Auditors' and users' impressions of different audit opinions in the U.K.	Compared to auditors, users felt generally less confident in financial statements containing going concern audit opinions.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

TABLE 2.1 (continued)

Author(s) and Year of Study	Purpose of Research	Summary of Findings
Citron and Taffler (1992)	Auditor switching, self-fulfilling prophecy as consequences of going concern opinions in the U.K.	An association between going concern opinions and auditor switching. No evidence of self-fulfilling prophecy.
Garsombke and Choi (1992)	Association between going concern opinions and company failures.	Companies with going concern opinions had failure rates higher than those with clean opinions.
Abbott (1994)	Audit partners' impressions of the going concern opinion.	Partners did not believe going concern opinions protected them from litigation.
Carsello and Palmrose (1994)	Auditors' protection from litigation due to issuing going concern opinions.	Plaintiffs with modified reports had weaker claims and collected less money.
Johnson and Khurana (1995)	Impact of SAS No. 59 on bankrupt companies' audit reports.	More bankrupt companies received going concern opinions after SAS No. 59.
Raghunandan and Rama (1995)	Auditors' propensity to issue going concern opinions, and bankrupt companies' likelihood of receiving them after SAS No. 59.	Auditors more likely to issue going concern opinions after SAS No. 59. More bankrupt companies received such opinions.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

TABLE 2.1 (continued)

Author(s) and Year of Study	Purpose of Research	Summary of Findings
Carsello, Hermanson, and Huss (1995)	Auditors' likelihood of issuing going concern opinions after SAS No. 59.	Auditors not more likely to issue modified reports to bankrupt companies after SAS No. 59.
Louwers, Messina, and Richard (1996)	Going concern opinions as warning devices for bankruptcy.	A significantly high percentage of companies survived their first modified report.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Information Content Market Studies

A number of capital market studies have investigated the information content of qualified opinions. A review of these studies, their implications, and their limitations, follows.

Alderman (1977) measured the impact of qualified opinions on the market's assessment of two risk components: systematic risk and unsystematic risk. The sample consisted of 20 firms that received uncertainty qualified opinions in the 1968 to 1971 period. The control sample consisted of 20 firms that received unqualified opinions in the period 1965 to 1974. An examination the stock price of each firm in the sample before and after receiving the opinion determined changes in risk. The study found no significant differences between the experimental sample and the control sample. The author concluded that uncertainty qualifications had little information value regarding risk to investors.

Firth (1978) tested the impact of qualified opinions in the U.K. He examined data for the 1,500 largest U.K. firms who had their audit opinions qualified in the 1974-75 period. The study used the market model and compared the actual returns of a security against those expected if there were no qualified opinion. Firth divided the sample into (1) general qualifications, (2) going concern, (3) asset valuation, (4) subsidiary's audit, and (5) continuing qualifications. The results indicated significant negative returns associated with

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

general qualifications, going concern, and asset valuations. The other qualifications exhibited little or no negative returns.

Banks and Kinney (1982) examined the impact on stock prices of different methods for reporting loss contingencies covered by FASB No. 5. The auditors' reporting options consisted of either a footnote disclosure only or a qualified opinion along with a footnote disclosure, depending on the auditors' judgement regarding the uncertainty's resolution. Their study controlled for the sign of the unexpected earnings and the footnote disclosure of the uncertainty which Alderman (1977) had ignored. The authors compared control and experimental samples consisting of 92 companies each and compared their stock returns. Firms in the experimental sample had loss contingencies in some years from 1969 to 1975. Firms in the experimental sample had significantly worse performances than those in the control sample. Returns for firms with qualified opinions and footnote disclosures differed from those in the control sample by more than those with only footnote disclosures. The authors argued that the audit report did not constitute the only way to learn about the uncertainty, but the study confirmed the report's importance. Therefore, Banks and Kinney concluded that qualified opinions had information content.

Elliott (1982) examined the methodologies of previous information content studies. He noted that auditors had issued qualified opinions in conjunction with other information of differing significance. This therefore,

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

made it difficult to measure the impact of qualified opinions separately. Bailey (1982) also had noted this limitation. Elliott found significant negative security returns before the release of qualified opinions. This indicated that market participants learned of expected qualified opinions using available information before seeing the audit opinion.

Dodd et al. (1984) examined abnormal stock returns associated with announcements of qualified opinions and disclaimers of opinions. They found that many firms experienced abnormal negative performance before the announcement of qualified opinions, but not after the announcement. However, the authors noted that their studies, like previous studies, had two limitations: (1) the problem of determining the exact timing of the audit report announcement, and (2) the problem of separating the audit report effect from other concurrent announcements. This study also noted that disclaimers of opinions appear to have very little information content.

Dopuch, Holthausen, and Leftwich (1986) attempted to overcome limitations in previous studies by determining the information content of "subject to" opinions. They examined 109 companies which received qualified opinions during the 1970 to 1979 period. They investigated whether *media releases* (such as in the *Wall Street Journal*) of qualified opinions produced different results from 10-K filings investigated in most capital market studies. The study found significant negative returns associated with *media releases* of these opinions. The authors indicated their inability to reconcile their findings

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

with previous findings because they could not identify the selection process that the media employed to release only certain companies' opinions. In general, they warned of the difficulties associated with detecting the information content in "subject to" opinions.

Hopwood, McKeown, and Mutchler (1989) tested the information content of going concern and other qualified opinions as predictors of bankruptcy. If proven accurate, these opinions could have served as warning signals to users. The sample consisted of 60 companies that declared bankruptcy between 1974 to 1981. The researchers selected a control group of 55 companies for the same period; Additionally they selected a holdout experimental group and a control group of 32 bankrupt companies for the 1982 to 1985 period. Holdout group data indicated the prediction accuracy of the opinions. Hopwood, McKeown, and Mutchler concluded that the going concern modified report and qualified opinions had incremental information content that could have served to predict bankruptcy. The study supported users' arguments that qualified opinions (including going concern) served as useful red flags.

Loudder et al. (1992) incorporated an expectations variable in determining the information content of qualified opinions. Specifically, the authors measured the market's assessment that auditors would issue qualified opinions instead of subjecting users to surprise issuances. The sample consisted of 101 firms with "subject to" opinions between 1983 and 1986. Loudder et al.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

divided the sample into two groups, expected firms and unexpected firms. The results showed significant negative market reaction to *unexpected* qualifications and to delayed issuances of *expected* qualifications. The authors argued that "subject to" opinions had information content, thus rendering their elimination premature.

Choi and Jeter (1992) provided further evidence of qualified opinion information content. They argued that qualified opinions had the potential of affecting the market's expectation by signaling more noise or less persistence than expected in the earnings numbers. To determine the impact of these opinions on ERC (Earnings Response Coefficients), or the market's response to earnings announcement, they sampled 72 companies receiving qualifications from 1983 to 1986. They divided the qualifications into going concern qualifications and all others. They then compared ERC for pre-qualification periods with those in periods after receipt of qualifications. The results indicated that the market based less reliance on reported earnings in the going concern violation sample--before and after the qualifications--than in the other sample. ERC declined significantly after the qualifications for both going concern and other qualifications. However, the going concern sample had a less significant decline. These results showed that qualified "subject to" opinions carried information by increasing users' uncertainty about the financial statements, and they resulted in negative returns.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Frost (1994) extended this line of research by examining the company's risk characteristics as perceived by investors if it received an uncertainty-related modified report. Frost argued that a high-risk company receiving a modified report could have less negative returns than a low-risk company receiving such an opinion. She gathered data on 234 companies in the period from 1983 to 1988 and divided the companies into high-risk and low-risk groups. The results confirmed the hypothesis. Low-risk companies experienced higher abnormal negative returns after receiving uncertainty-modified reports than did high-risk companies. The market, therefore, revised its expectations about the company after learning of the uncertainty through the audit report. Uncertainty-modified reports, therefore, had information content.

Ameen, Chan, and Guffey (1994) investigated the information content of qualified opinions for Over-the-Counter (OTC) firms. They noted that previous studies used NYSE and ASE firms and that the results could not extend to smaller firms traded in the OTC market. The sample consisted of 177 firms receiving qualified opinions from 1974 to 1988. The results indicated that the market reacted negatively prior to the initial public announcement of the qualification, but not after the announcement or around it. Negative returns occurred because of the market's expectation relative to the uncertainty. No further negative returns occurred around the announcement date. They concluded that the announcement of qualified opinions did not have information content.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Fleak and Wilson (1994) studied *unexpected* going concern opinions as possible causes of negative returns. Their study defined an unexpected going concern opinion as one which differed from what would be expected based on previously available information about the company. Their sample consisted of 495 companies receiving going concern opinions from 1979 to 1986. The study separated the companies into those likely to receive going concern opinions and those not likely to receive such an opinion based on two models. The results indicated that only *unexpected* going concern opinions coincided with abnormal negative returns. The results did not show any association between unexpected clean opinions and positive abnormal returns. This study demonstrated that market participants reacted only to negative surprises and that expected going concern opinions had no information content.

Seipell and Tunnell (1995) tested the impact of going concern opinions on 75 firms' unsystematic and systematic risks. They studied the 1983 to 1987 time period. The study matched and compared experimental firms that received going concern opinions with control firms that did not receive such opinions. The results revealed an association between an increase in unsystematic risk and a going concern qualified opinion. This study addressed the problem of trading frequency. Scholes and Williams (1977) had found that returns for less frequently traded securities had a downward bias. Seipell and Tunnell's results indicated the presence of the trading frequency problem. After allowances for this problem, systematic risk did not increase with the

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

issuance of going concern opinions. The authors noted that previous studies with such an association may have suffered from the nonsynchronous (i.e., trading frequency) problem.

Chen and Church (1996) examined the market's expectation of bankruptcy based on going concern opinions. They used a sample of 98 bankrupt companies from 1980 to 1988. They separated the sample into companies that received going concern opinions and those that received clean opinions, and they compared returns around bankruptcy. The results revealed that firms receiving going concern opinions before bankruptcy experienced less negative returns around bankruptcy than those that received clean opinions. This indicated that going concern opinions had information content and that they warned the market about forthcoming bankruptcies.

Summary

The previous studies examined the information content of qualified opinions. For the most part, going concern opinions proved useful in predicting bankruptcy. Unexpected qualified opinions also proved useful in revising risk profiles, and they resulted in abnormal negative returns. However, different methodologies and time periods made these studies' findings difficult to compare. Table 2.2 summarizes the results of these studies.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

TABLE 2.2

INFORMATION CONTENT MARKET STUDIES

Author(s) and Year of Study	Purpose of Research	Summary of Findings
Alderman (1977)	Impact of a qualified opinion on a firm's risk assessment.	Uncertainty qualifications had little or no impact on risk assessment.
Firth (1978)	Impact of different types of qualifications on security returns in the U.K.	Only going concern, general, and asset valuation qualifications had information content.
Banks and Kinney (1982)	Impact of uncertainty reporting and its method on security returns.	Uncertainties led to abnormal negative returns. Qualified opinions and footnotes had more information content than footnotes alone.
Elliott (1982)	Methodological issues and the association between qualified opinions timing and security returns.	Significant negative returns occurred before the release of qualified opinions.
Dodd et al. (1984)	Relationship between announcements of qualified opinions and stock prices.	Abnormal negative returns occurred before, but not around or after, announcements of qualifications.
Dopuch, Holthausen, and Leftwich (1986)	Comparative security price impacts: media disclosure of qualified opinions vs. 10-K filings.	More negative returns associated with media disclosure of qualifications than with routine 10-K filings.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

TABLE 2.2 (continued)

Author(s) and Year of Study	Purpose of Research	Summary of Findings
Hopwood, McKeown, and Mutchler (1989)	Association between qualified opinions and bankruptcy.	A strong association between going concern opinions and bankruptcy.
Loudder et al. (1992)	Incorporated earnings expectations into information content studies of qualified opinions.	Disclosure of unexpected qualified opinions resulted in negative returns, as well as delayed disclosures of expected qualifications.
Choi and Jeter (1992)	Impact of qualified opinions on Earnings Response Coefficients.	Negative market responsiveness to qualified opinions; the opinions increased earnings noise, and they decreased persistence.
Frost (1994)	Relationship between uncertainty- qualified opinions given to high-risk firms as compared to low-risk firms.	Low-risk firms receiving qualified opinions showed greater negative returns than high-risk firms receiving them.
Ameen, Chan, and Guffey (1994)	Information content of qualified opinions for smaller OTC firms.	Abnormal negative returns before the announcement date, but not around it or after it.
Fleak and Wilson (1994)	Difference between expected and unexpected going concern opinions on stock prices.	Only unexpected going concern opinions were associated with abnormal negative returns.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

TABLE 2.2 (continued)

Author(s) and Year of Study	Purpose of Research	Summary of Findings
Seipel and Tunnell (1995)	Relationship between going concern opinions and changes in unsystematic and systematic risk.	Going concern opinions increased unsystematic risk, but not systematic risk.
Chen and Church (1996)	Usefulness of going concern opinions in signaling bankruptcy.	Firms receiving going concern opinions experienced less negative returns around bankruptcy than those receiving clean opinions.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Information Content Experimental Studies

Few experimental studies have examined the information content of qualified opinions in the U.S. The experimental studies which have been conducted typically have focused on users' reactions to different qualifications and to different methods of reporting them.

Estes and Reimer (1977) examined the effect of a qualification due to a minor violation of APB No. 18 where the company carried certain investments at cost instead of equity. Two groups of bankers responded to a mail questionnaire. One group received a cover letter and descriptive information about the company, a set of financial statements and footnotes, and an unqualified audit opinion. The other group received identical information, but with a qualified opinion. The footnotes for both groups included a description of the departure from APB No. 18. The bankers provided a loan amount that they would approve for each company. The results indicated no significant difference in both groups' mean loan amounts.

Firth (1979) investigated the impact of going concern qualifications on bankers' decisions in the U.K. The sample consisted of several groups of bankers who received the same information--except for the type of audit report--about a company. The audit reports were unqualified, qualified due to a going concern uncertainty, qualified due to asset valuation problems, and qualified due to a departure from GAAP. The bankers indicated the maximum amount that they would lend to each company. The mean loan amounts

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

ranged from 11 million British Pounds for unqualified opinions to 0.7 million British Pounds for going concern qualifications. These results indicated a significant difference in the risk perception based on clean opinions and going concern opinions. Significant differences also occurred because of asset valuation qualifications.

Estes and Reimer (1979) provided another study of qualified opinion information content. After examining the financial statements and "except for" qualified audit opinions for a number of companies, 1,000 financial analysts estimated the per-share market value of a composite firm's stock. That composite firm data represented average account balances for five real manufacturing firms. The authors attempted to attribute any significant difference in decisions to the audit report and not to the company's financial statements. To achieve this goal, they designated a violation of APB No. 18 as the independent variable. They presented two groups of financial analysts with the same information, except for the audit report. Financial analysts who reacted to the "except for" opinion estimated a significantly lower stock price than analysts who reacted to the unqualified opinion. The authors concluded that qualified opinions had information content to financial analysts. This is contrary to the results of their earlier (1977) study which showed no information content to bankers.

Libby provided two significant studies in this line of research concerning the impact of uncertainties on bank loan officers' perceptions and decisions.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Libby (1979a) presented loan officers with 10 different kinds of audit opinions to test their understanding of the meaning of each opinion and compared their understanding with that of CPAs'. The opinions ranged from unqualified to qualified because of uncertainties to disclaimers of opinions. Libby asked bankers and auditors to answer a number of questions about the reliability of the financial statements and their usefulness. The results indicated no significant differences between auditors and bankers in interpreting the meaning of the audit opinions. The study also showed that uncertainty qualifications, by themselves, increased bankers' perception of loan risk. The latter finding suggested that qualified opinions due to uncertainty had information content.

In a related study, Libby (1979b) examined the location and method of disclosing uncertainties. The uncertainty concerned litigation for a defendant company in a lawsuit. Libby divided loan officers into three groups. Each received an unqualified opinion, a disclosure only, or a disclosure with a qualified opinion. The loan officers estimated the appropriate interest rate to charge above the prime rate. The results showed that the disclosure of the uncertainty increased bankers' risk perception. However, adding a qualified opinion to a footnote disclosure did not affect risk perception. This study did not find information content in qualified opinions, and it supported the CAR's recommendation to eliminate them. Libby concluded that qualified opinions were redundant in the presence of appropriate footnote disclosure. Berthold

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

(1979) and Schultz (1979) criticized Libby's study because Libby had enclosed a statement predicting the outcome of the uncertainty. Therefore, the test contained no genuine uncertainty. However, Libby's study did provide an important insight into banker perceptions of qualified opinions.

Firth (1980) extended his earlier study of bankers' decision making in the U.K. The later study investigated whether qualified opinions affected bankers' lending decisions. Firth mailed financial statements of two hypothetical companies to loan officers; those two companies differed only by audit report type. Company A was in good financial condition and company B was in poor condition. Firth asked the bankers to state the maximum loan amount they would grant to each company. The audit opinions varied as follows: (1) unqualified, (2) qualified due to going concern uncertainty, (3) qualified due to asset valuation, and (4) qualified due to departure from GAAP. The results indicated significant differences in loan amounts between the company with a clean opinion and the one with a going concern qualified opinion. The company with a going concern opinion would have received a substantially smaller loan than the one with a clean opinion. This study, indicated that, in the U.K., qualified opinions had information content.

Houghton (1983) investigated the information content of qualified opinions in Australia. The sample consisted of 247 bank loan officers who received a loan application from a hypothetical company. Houghton divided the sample into two groups. One group received information about the

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

company and an unqualified opinion. The other group received the same information about the company and a qualified audit opinion. The qualification referred a lawsuit against the company. The results indicated no significant differences in bankers' decisions about the company with a qualified opinion and the one with the unqualified opinion. The author attributed the lack of information content to either the audit report's having no importance in decision making or to the audit report's having less importance than other information in the financial statements.

Abdel-khalik, Graul, and Newton (1986) extended Libby's (1979b) study to a Canadian environment. Auditors no longer issued qualified opinions in Canada at the time of this study, and, therefore, the environment differed from the one in the U.S. The sample consisted of commercial loan officers who received financial information about several companies and several different audit report types. Some audit reports had unqualified opinions, some had a "two-sided opinion" indicating that presentation in the U.S. would require a qualification, and some had a "subject to" qualified opinion due to an uncertainty involving litigation. Each banker assessed each firm's risk (measured as an interest rate premium), and each banker estimated the probability of each firm's default. The study's research design attempted to overcome Libby's problems. The findings showed that bankers regarded disclosure of the uncertainty as relevant information. However, the addition of a "subject to" qualified opinion had no significant impact on bankers' decisions

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

beyond what a footnote only would disclose. These findings supported the CAR's recommendation to eliminate uncertainty qualified opinions because of their redundancy.

Gul (1987) tested the information content of qualified opinions in Singapore. The study used an actual company with a fictitious name in an experiment to compare the effects of qualified opinions and footnotes on bankers' decisions. Gul studied the effects of three reporting methods: (1) no uncertainty disclosure, (2) a footnote disclosure only, and (3) a "subject to" qualified opinion and a footnote disclosure. The uncertainty concerned pending litigation. Each banker estimated an interest rate premium for a loan granted to this company. The results indicated that for every additional level of disclosure, the bankers had an increased perception of risk. Qualified opinions, therefore, had information content to Singapore bankers. This conclusion did not support the CAR's recommendation to eliminate them.

Pringle, Crum, and Swetz (1990) provided an early modified report impact study on going concern uncertainty due to risk. They divided the undergraduate student subjects into two groups. The first group received five sets of financial statements (including footnotes) accompanied by qualified opinions due to going concern uncertainty for actual companies. The other group received identical financial statements accompanied by modified reports (opinions with explanatory paragraphs) due to going concern uncertainty. The students ranked the five companies in terms of investment potential. The

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

authors employed a between-groups and within-groups design to examine differences in company rankings. The results indicated no significant differences between subjects who received qualified opinions and those who received modified reports. The method of reporting going concern did not matter as long as the auditor communicated the message. Within-subject comparisons revealed that subjects who received qualified opinions had *more similar* rankings compared to subjects who received modified reports. The authors attributed this within-subject difference to increased confusion caused by an unqualified opinion with an explanatory paragraph. This confusion, real or imaginary, strongly supported the CAR's recommendation to eliminate all reference to the uncertainty in the audit report.

Houghton and Messier (1991) examined the effect of qualified opinions on auditors and bankers. The sample consisted of Florida bankers and auditors. They utilized six types of audit reports: (1) unqualified, (2) qualified due to departure from GAAP, (3) qualified due to scope limitation, (4) modified due to uncertainty, (5) adverse due to departure from GAAP, and (6) disclaimer of opinion. The results indicated no significant differences in the meanings of audit reports between bankers and auditors. However, auditors viewed the wording of the modified report due to uncertainty as *more negative* than the bankers, who saw it as neutral. The study did not clearly define uncertainty, and the wording of the modified report differed from the wording of SAS No. 58 or SAS No. 59.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

LaSalle and Anandarajan (1997) compared the influences of a modified report due to uncertainties and a disclaimer of opinion on bankers' decisions. They provided information about two actual companies to 490 loan officers. The first company had a material lawsuit uncertainty, and the second company had going concern uncertainty. They divided the sample into two groups who received reports for both companies. Each participant received either a modified report with an explanatory paragraph or a disclaimer of opinion for each company. Participants granted or rejected a requested line of credit to each company. None of the loan officers granted the line of credit for the firm with a disclaimer of opinion, while only 9% agreed to the line of credit for the firm with going concern uncertainties, but 42% approved credit for the firm with other uncertainties. The authors concluded that the method of reporting mattered less for firms with going concern uncertainties than for firms with other uncertainties. These results suggested that going concern uncertainties, rather than the auditor's method of reporting, caused credit rejection.

Bamber and Stratton (1997) provided evidence that the audit report modified for other uncertainties had information content. In this case, the uncertainty involved a potential litigation loss. They surveyed 77 bank loan officers in seven banks and presented them with multi-year financial statements and the current year's footnotes that included the uncertainty. The study divided the participants into eight groups. Each participant in each group received information about two companies with either a standard audit report

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

or a modified report. The results showed that bankers granted a loan less often to a company with a modified report compared to a company with a standard report and assigned a higher interest rate premium to the former company. The bankers also weighted the modified audit report and the footnote as more important in their decision compared to the standard report.

Summary

The previous experimental studies provided mixed evidence on the information content of qualified and modified reports. Most of the studies conducted in the U.S., Canada, and Australia found no significant information content of these opinions, while studies conducted in other countries found significant information content. The following table summarizes those studies.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

TABLE 2.3

INFORMATION CONTENT EXPERIMENTAL STUDIES

Author(s) and Year of Study	Purpose of Research	Summary of Findings
Estes and Reimer (1977)	Impact of qualified opinions on bankers' decisions.	No difference between amount loaned to firms with unqualified opinions accompanied by foot-notes and firms with qualified opinions ac-companied by footnotes.
Firth (1979)	Impact of qualified audit opinions for different reasons on bankers in the U.K.	Qualified audit opinions due to going concern and asset valuation had significant impacts on bankers' credit decisions.
Estes and Reimer (1979)	Impact of qualified opinions on financial analysts' stock price estimates.	Financial analysts assigned higher risk (lower stock price) to a company with a qualified opinion than to a comparable same company with a clean opinion.
Libby (1979a)	Difference between auditors' and bankers' perceptions of different audit opinions.	No difference between bankers' and auditors' perceptions. Uncertainty reporting increased risk perception.
Libby (1979b)	Impact of uncertainty reporting method on bankers' loan decisions.	Qualified opinions were redundant in the presence of footnote disclosures.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

TABLE 2.3 (continued)

Author(s) and Year of Study	Purpose of Research	Summary of Findings
Firth (1980)	Impact of different qualified opinions for two companies on bankers' decisions in the U.K.	Qualified opinions due to going concern uncertainty and asset valuation had significant information content.
Houghton (1983)	Impact of qualified opinions due to litigation uncertainty on bankers in Australia.	No significant information content difference between a qualified opinion and only a footnote disclosure.
Abdel-Khalik, Graul, and Newton (1986)	Extended Libby's (1979b) study in Canada. Impact of qualification on loan risk.	No significant risk difference between qualified opinion with footnote and only footnote. Similar to Libby's (1979b) conclusion.
Gul (1987)	Bankers' perception of risk in Singapore due to uncertainty qualifications	Risk perception increased with every additional level of disclosure.
Pringle, Crum, and Swetz (1990)	Risk perception difference between qualified and modified reports due to going concern uncertainty.	No difference between qualified opinions and modified going concern reports.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

TABLE 2.3 (continued)

Author(s) and Year of Study	Purpose of Research	Summary of Findings
Houghton and Messier (1991)	Difference in audit report meaning between auditors and bankers.	No difference in meaning perception between auditors and bankers. Auditors viewed modified reports as more negative than bankers.
LaSalle and Anandarajan (1997)	Difference in bankers' risk assessment based on modified reports and disclaimers of opinions due to other uncertainties and going concern uncertainty.	More bankers rejected a credit line for going concern uncertainties than for other uncertainties. Reporting method made a difference only with other uncertainties.
Bamber and Stratton(1997)	Information content of modified audit report due to a potential litigation loss compared to an unqualified opinion.	Bankers granted a loan less often to a company with a modified report compared to a company with an unqualified opinion. The modified report due to other uncertainties had information content to bankers.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

The previous literature review indicated the auditing profession's concern about the expectation gap. The ASB issued SAS No. 58, SAS No. 59, and recently amended SAS No. 58 to deal with this issue. The capital markets literature partially supported users' argument for the usefulness of warning signals. However, most of the experimental studies in the U.S. have shown that qualified or modified reports, even those concerning going concern uncertainties, contained no significant warning signals beyond what appropriate footnotes disclosed. The following chapter addresses the current study of modified report information content.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

CHAPTER 3

RESEARCH METHODOLOGY

This chapter discusses the research methodology employed in this study. It presents the theory leading to the research, as well as the study's hypotheses. Discussions of the experimental design, the sample, and the statistical tests follow.

Theory and Hypotheses Development

As presented in the previous chapter, substantially less research has examined the going concern explanatory paragraph in the audit report compared to the qualified "subject to" opinion. Therefore, this study has investigated the usefulness of the explanatory paragraph in decision-making and the existence or (non-existence) of additional signals attributable to it.

The theory behind the current study originated in the CAR's recommendation, as implemented by the ASB in SAS No. 59, and SAS No. 79, which dealt with going concern uncertainties. Previous experimental studies, especially those dealing with bankers, have reinforced that theory.

In 1978, the CAR recommended that the audit report not contain references to uncertainties, as long as footnotes provided adequate disclosures.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

The commission regarded the inclusion of this information in the audit report as redundancy that did not serve a useful purpose. The Commission noted, however, that users demanded appropriate disclosure of the uncertainty to draw their attention to the problem and to enable them to make informed decisions.

From the ASB's point of view, the going concern issue deserved special attention and warranted a special standard, SAS No. 59. However, the reasoning behind SAS No. 59 bore a similarity to that behind SAS No. 58, namely the auditor's responsibility to emphasize uncertainty in an explanatory paragraph. Many users did not fully understand the Board's objective and believed that the explanatory paragraph contained additional information on the uncertainty. This misunderstanding prompted the board to amend SAS No. 58 and eliminate the explanatory paragraph requirement.

The ASB revealed a major reason for issuing SAS No. 79 when it stated that: "The required uncertainties explanatory paragraph *does not* and *should not* communicate new information to financial statement users" (emphasis added). Therefore, if the ASB believed that the uncertainty paragraph merely emphasized the uncertainty as explained in the footnote, one could have reasonably hypothesized the same belief for the going concern uncertainty. At the time of this study, it appears that the ASB did not indicate the same belief for going concern uncertainty.

The foregoing has relied upon the CAR's recommendation, its implementation by the ASB, and the ASB's specific mention of the role of the

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

explanatory paragraph. It has led to a general hypothesis that the user will make the same decision based on an audit report with an explanatory paragraph as he will based on an audit report without the paragraph; the paragraph constitutes a redundancy (CAR), and it does not communicate new information (ASB, SAS No. 79).

Estes and Reimer (1977); Libby (1979b); Abdel-Khalik, Graul, and Newton (1986); Pringle, Crum and Swetz (1990); and LaSalle and Anandarajan (1997) tested this hypothesis. They all reached the same general conclusion: the method of reporting the uncertainty, including the going concern uncertainty, did not significantly affect users' decisions. This conclusion held for qualified opinions (Estes and Reimer (1977), Libby(1979b) and Abdel-Khalik, Graul and Newton (1986)) and for modified reports (Pringle, Crum, and Swetz (1990) and LaSalle and Anandarajan (1997)). In other words, the uncertainty itself, rather than the reporting method affected the decision. These findings contradicted users' arguments about the usefulness of the reporting method.

This study has tested four hypotheses relative to the information content of explanatory paragraphs.

Hypothesis 1. Bankers' estimate of the likelihood of granting a line of credit to a given company based upon a modified going concern report and a footnote disclosure would not differ substantially from the estimate to the same company on the basis of an unqualified opinion and a footnote disclosure.

Hypothesis 2: The interest rate that bankers would charge for a line of credit to a given company based upon a modified going concern report and a

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

footnote disclosure would not differ substantially from the interest rate the bankers would charge to the same company on the basis of an unqualified opinion and a footnote disclosure.

Hypothesis 3: Bankers' confidence in their lending decision for a given company based upon a modified going concern report and a footnote disclosure would not differ substantially from their confidence for a loan to the same company on the basis of an unqualified opinion and a footnote disclosure.

Hypothesis 4: Bankers' perception of bankruptcy likelihood for a given company based upon a modified going concern report and a footnote disclosure would not differ substantially from their perception about the same company on the basis of an unqualified opinion and a footnote disclosure.

The first hypothesis addressed the company's relative risk, with the expectation that lower likelihood of granting the line of credit would coincide with loan officers' perceptions of higher risk. The interest rate that a bank would charge on a line of credit could also serve as an estimate of risk. The second hypothesis, in the null form, therefore, has addressed that aspect of risk measurement.

As its secondary objective, this study sought to determine the "side effects" of the going concern explanatory paragraph. According to the CAR, the clause "subject to" gave some users the false impression that upon resolution of the uncertainty, the company would restate its financial position. While the going concern explanatory paragraph continued to contain a statement that "the financial statements did not include any adjustments that might result from the outcome of this uncertainty," users' interpretation of that statement remained unclear. Any confusion, however, should tend to undermine users' confidence in the financial statements. Accordingly, the

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

third hypothesis addressed the issue of loan officers' confidence in their decision.

In making its recommendation to eliminate qualified opinions, the CAR noted that some users believed that the absence of a qualification indicated no uncertainties. However, the commission noted that all businesses faced a certain degree of risk, and they considered a user misperception undesirable. The previous arguments have led to the assumption that users receiving a modified report (i.e., an explanatory paragraph) would perceive a higher degree of uncertainty (bankruptcy in the case of going concern modified reports) as opposed to users receiving an unqualified opinion (i.e., with no explanatory paragraph). Hypothesis 4 addressed this concern.

Research Method

Experimental Design

This study utilized an experimental method, sometimes called intact equivalent design, to test the four hypotheses. It divided the subjects into two groups that resembled each other as much as possible. As noted by Bailey's (1982) criteria, this served as an appropriate design for testing the effect of audit opinion attributes; it avoided the major problem associated with market studies, namely audit reports released concurrent with financial information. Those concurrent releases generally have added to the difficulty of separating the effect of the audit report from the financial information.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

The two groups made particular estimates and indicated certain perceptions. The intact equivalent design method compared the results in a between-groups analysis. Pany and Reckers (1987) had examined the merit of within-subjects vs. between-subjects designs and concluded that between-subjects designs produced superior analyses. Applying Pany and Reckers' arguments to the current study, if within-subjects design was used, it would have been possible for a respondent to express his individual preference for the explanatory paragraph regardless of its actual information content. The between-subject design avoided this problem by presenting each subject with only one alternative.

Kinney (1986) had offered a discussion of common problems with between-subjects designs. He had noted that in order to measure the effect of X (treatment) on Y (decision), the researcher had to recognize V's (other factors) that may have influenced Y. Relevant V's, according to Kinney (1986) included the subjects' personality traits, mathematical ability, education, experience, and firm association. This study treated the presence of V's through two approaches. First, the study specifically incorporated other factors possibly affecting a lending decision into the decision-making model and recognized that those factors may have had an impact on the different Y's. Specifically, lending officers' experience, accounting education, auditing education, and bank size comprised the V's.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

The study then randomized away the remaining V's (individual respondent's risk preference or individual bank risk preference) in the total sample. On average, this made the two groups equivalent on the V's. In as much as possible, this design isolated the effect of the treatment on the lending decision. In terms of the previous discussion this exposed one group to a modified going concern audit report, and it exposed the other group to an unqualified audit opinion. Both groups had access to the same financial statements and company information.

<u>Sample Selection</u>

The subjects of this study consisted of commercial loan officers. The study used them because of the lending decision's importance to companies who frequently resort to bank financing. Lending decisions also mattered to the ASB because bankers make extensive use of financial information (Stephens (1980)) and the audit report. Any inappropriate reporting policies by the ASB, therefore, can have consequences on both bankers and companies. Users, including bankers, also provided the most input to SAS No. 59 exposure draft which indicated that they considered going concern reporting a major issue.

The sample for this study was selected from a database provided by the Polk Bank Directory. That database provided addresses of loan officers at different banks around the country. The study targeted no particular geographic area. The loan officers received the questionnaire in their offices

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

and worked in banks with at least $100 million of assets. Two factors made the last condition necessary. First, smaller banks may or may not have required audited financial statements in a lending decision; therefore, these loan officers may or may not have understood the different types of audit reports. Second, the study used an actual public company (as explained later) that made it necessary for sampled banks to have the ability to lend money to such a customer. Since most smaller banks face capital constraints and probably do not deal with such companies, loan officers of smaller banks may not have provided realistic responses.

Each selected banker received an actual company's financial statements, an audit report, footnotes, and a questionnaire. Each of the two equal groups in the sample received the same information except for the audit report. One group received a going concern modified audit report and a footnote explaining the going concern situation. This is the current practice required by SAS No. 59. The other group received an unqualified audit opinion and the same footnote. This is not the current way of reporting going concern uncertainty.

Case Company

Data for the company selected as a case example appeared in the Compact Disclosures database and met four criteria: (1) the company had publicly traded--and still actively traded--stock (i.e., had not declared bankruptcy); (2) it had received a going concern opinion in the most recent

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

annual report; (3) it had at least one shareholder, one employee, a positive cash balance, inventory; and finally, (4) it was incorporated in the U.S.

After determining the pool of companies that met the stated criteria, the screening process considered the company's industry, audit report modification, and size. The process eliminated companies in industries such as oil and gas and medical technology due to the possible unfamiliarity of many loan officers with their business conditions. The process then examined audit report modifications to eliminate any companies that received a modification for reasons other than going concern uncertainties, or in addition to such uncertainties. For example, some companies faced several uncertainties such as a lawsuit requiring an explanatory paragraph, as well as going concern difficulties requiring another explanatory paragraph. The process eliminated such companies because of uncertainties as to whether loan officers would have reacted to the other uncertainty paragraph, the going concern issue paragraph, or both. Also, the screening process eliminated companies that recently had adopted a new FASB standard or otherwise changed accounting methods. Finally, the process reviewed each company's size in terms of total assets and total sales in order to match the sample company's needs with the lending capacities of the banks included in the survey.

Case Development

The company actually chosen manufactured and distributed cosmetics and other beauty products and qualified as a "typical customer" for many banks,

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

especially with its $10 million in assets and $32 million in sales. Information related to the business, stock prices, ownership, and employees was taken from the firm's most recent 10-K report. The information package also included condensed financial statements, the audit report, and relevant footnotes in summarized form. However, the going concern footnote appeared exactly as written in the Form 10-K for that year.

In the next case development step, selected loan officers reviewed the case and the questionnaire. The loan officers indicated the need for additional information about the company's business, as well as a summary of its outstanding debts. They also suggested that an appropriate loan amount for this company would be in the $750,000 - $1 million range. That amount matched the minimum reasonable requirements of the sample company with the lending capacities of surveyed banks. They also indicated that the information package should include the purpose of the loan and available collateral; they assigned little likelihood to a bank's granting an unsecured line of credit. The discussions with the loan officers led to the choice of a one-year secured working capital line of credit in the range of $750,000 - $1 million, with the accounts receivable and inventory serving as collateral.

The information package withheld the name of the company and its subsidiaries to avoid biasing their opinion for or against this company. Some of these bankers may have dealt with this company or known about it. The

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

package did not reveal the audit firm name. A sample of the case study is provided in Appendices A and B.

Questionnaire and Task

The cover letter did not specifically reveal the purpose of the study in order to avoid the influence of the bankers' personal opinions regarding the explanatory paragraph on the decision. However, the cover letter noted that the study addressed risk. Completing the survey instrument required no more than 20 minutes of each respondent's time. The consulting loan officers deemed this range reasonable. Appendix A also includes a copy of the questionnaire.

The first group of questions asked the loan officers to estimate the likelihood of their granting the requested line of credit. The questionnaire provided a seven-point Likert scale for that answer. The phrasing of the question controlled for accountability in organizations. According to Fandt and Ferris (1990), accountability can cause employees to make more conservative decisions. In this case, it could have caused the loan officers to reject the line of credit for reasons unrelated to the study. The questionnaire then asked the loan officers to estimate a risk premium above the prime rate. Because banks have different prime rates, the questionnaire gave a specified prime rate as a starting point.

Other questions were designed to measure bankruptcy estimate and confidence levels. They, also, utilized a seven-point Likert scale. Finally, the

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

questionnaire asked for demographic characteristics such as experience, accounting education, auditing education, and bank size. These characteristics possibly could serve as explanatory variables that could have influenced different estimates.

Statistical Tests

The statistical tests employed to test the hypotheses depended, among other things, on the measurement scale used to measure the estimate or the perception. Several types of scales exist: Nominal, ordinal, interval and ratio. This study used ordinal and interval scales. An ordinal scale implies a statement of "greater than" or "less than" where if $a>b$ and $b>c$ then $a>c$ without stating how much greater or less. Emory and Cooper (1991) explained that an ordinal scale is like a rubber yardstick that can stretch varying amounts across its length. Thus, the real difference between 1 and 2 may be more or less than the difference between 2 and 3. Interval scales ,on the other hand, require that the distance between 1 and 2 equals the distance between 2 and 3. Mathematical computations can be used on interval scales where the mean is the measure of central tendency.

It is important for the researcher to correctly classify a measurement scale since the statistical tests employed will depend on this classification. For example, parametric statistics, such as ANOVA, are usually more powerful tests than nonparametric tests such as chi-square tests. However, parametric tests can only be used with a measurement scale that is at least interval, provided

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

that other assumptions are met, as explained later. The questionnaire used in this study gathered information from bankers through two methods: a seven-point Likert scale where the respondent had to estimate his perception on this scale and an interest rate estimate where the respondent estimated an actual interest rate. Although the latter form of measurement is easy to classify as interval, the former scale is not easily classified.

According to Emory and Cooper (1991), many behavioral researchers use Likert scales as interval scales and therefore apply parametric tests to the data. Seigel and Castellan (1988) noted that the researcher would actually be adding information if he used parametric tests on data that was less than interval because he was assuming that the distances within the scale were equal. On the other hand, Anderson (1980) noted that the difference between parametric and nonparametric tests was not great insofar as significance level and power were concerned. Therefore, the type of measurement scale used had little relevance in selecting the statistical tests.

Srinivasan and Basu (1989) noted that ordinal scales were easy to use and they generated a higher response rate. They also noted that continuous variables gave a false sense of precision since most subjects would choose multiples of 10 when responding on a scale of 1 to 100, for example. Srinivasan and Basu showed that ordinal scales could be used as metric measures with very little loss of information resulting from a smaller interval and they quantified this loss of information. Assuming that Likert scales were

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

ordinal scales, they developed an index of metric quality defined as the ratio of the predictive power of the ordered categorical variable to the predictive power of the underlying continuous variable. They found that the loss of information was less than 10% when at least a five point scale was used. Therefore, they recommended the use of a scale of at least five equal categories.

Because the issue of treating a Likert scale as ordinal or interval was controversial, this study employed both parametric and nonparametric tests on the data. Nonparametric tests were used to ease the restrictive assumptions underlying parametric tests.

Parametric Tests

Emory and Cooper (1991) noted that parametric tests, in general, make the following assumptions about the data. First, it is assumed that both group populations had a normal distribution. Second, it is assumed that these populations have equal variances and finally, the observations should be independent. They argued that some parametric tests were robust to minor violations of these assumptions while other tests were not.

Equality of Means

The t test measured the equality of the means of two independent samples. It tested whether the estimate or the perception made by the group receiving a modified report and footnote differed significantly from the one made by the group receiving the unqualified report and the footnote. The test

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

determined whether the mean likelihood of granting the line of credit differed significantly between groups, whether the level of confidence and bankruptcy perception differed, and whether the interest rate estimates differed. If the two sample means were found to be significantly different, the null hypotheses would be rejected and if the difference was not significant, they would not be rejected.

Ordinary Least Squares

Ordinary Least Squares (OLS) regression determined the impact, if any, of the explanatory variables on each estimate or perception. For example, did factors such as experience as a loan officer, accounting and audit education, and bank size affect the likelihood of granting the line of credit? In this case, the dependent variable consisted of the estimate (or the perception) and explanatory items comprised the independent variables. The study employed the following model, and it used Ordinary Least Squares separately for each estimate or perception.

$$Y = B0 + B1Parag + B2Exp + B3Acc + B4Audit + B5Size + e$$

where:

Y = the likelihood of granting the line of credit, the level of confidence, the estimate of bankruptcy (all on a 1 to 7 scale) and the interest rate estimate.

Parag = 1 if received the explanatory paragraph
0 if received only the footnote

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Exp = 1 if less than 5 years of experience
2 if between 5 and 10 years
3 if between 11 and 15 years
4 if between 16 and 20 years
5 if more than 20 years of experience

Acc = 1 if less than 2 accounting courses
2 if 2 or 3 courses
3 if 4 or 5 courses
4 if 6 or 7 courses
5 if more than 7 courses

Audit = 1 if respondent had an auditing course
0 if respondent did not have an auditing course

Size = 1 if between $100 and $299.9 million of assets
2 if between $300 and $499.9 million
3 if between $500 and $999.9 million
4 if between $1 and $4.9 billion
5 if over $5 billion of assets

e = the error term

B0 = the intercept

B1, B2, B3, B4 and B5 = parameters estimates.

If a statistically significant relationship was found between any of the explanatory variables and the dependent variable, this would be useful to companies in their search for a loan since granting it might depend on a particular loan officer or a particular bank.

Nonparametric Tests

According to Emory and Cooper(1991), nonparametric tests are most often used when the assumptions underlying the parametric tests are not met.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

They also noted the ease of use of these tests and that their efficiency is usually about 95% compared to similar parametric tests.

This study used the Kolmogorov-Smirnov two-sample test. This test is primarily concerned with the agreement between two cumulative distributions , but both represent sample values. The purpose of the test is to determine whether the two distribution functions associated with the two populations are identical or not. Therefore, it draws conclusions about the two group populations of bankers based on the two samples of respondents. Conover (1980) explained that other tests such as the median test or the Mann-Whitney test may detect differences between two means or medians, but they may not detect differences of other types, such as differences in variances. The advantage of the Kolmogorov-Smirnov test is that it is consistent against all types of differences that may exist between the two distribution functions. This test assumed only that the two samples were random samples and that they were mutually independent. According to Conover (1980), for this test to be exact, the random variables were assumed to be continuous. However, the test was still valid with discrete variables and produced conservative results. This meant that approximate results would be obtained that would be slightly larger than actual results.

If F(X) represents the distribution function of the group receiving the modified report and the footnote diclosure while G(X) represents the distribution function of the group receiving the unqualified report and the

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

footnote disclosure. The null hypothesis in this case would be that $F(X) = G(X)$ and the alternative hypothesis would be that they were not equal. The test proceeded by calculating the maximum absolute difference between the two distribution functions and compared this calculated difference against a tabulated difference. The significance level for a two-tailed test was set at 0.10. If the calculated difference was larger than the tabulated difference, the null hypothesis was rejected and concluded that the explanatory paragraph had information content, and if it were smaller, the null hypothesis could not be rejected.

Summary

This chapter presented the theory leading to the study's hypotheses, the case selection and development procedures and the statistical tests employed. Parametric (t-test and regression) and nonparametric tests (the Kolmogorov-Smirnov test) were employed depending on the type of scale used and the assumptions about the data.

The following chapter presents the results of the data analysis. This is followed by the results of the different statistical tests employed and the general conclusions of these results.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

CHAPTER 4

DATA COLLECTION, ANALYSIS, AND RESULTS

The purpose of this chapter is to discuss the survey data collection procedures and results. It explains the two major parts of data collection: the pilot study and the main study. A discussion of the response rate as well as the sample characteristics is presented. In addition, a test of potential nonresponse bias is discussed. This is followed by a review of the data analysis methods and hypotheses tests.

Data Collection Procedures

To collect the survey data, two phases were essential: the pilot study and the main part of the study.

The Pilot Study

The pilot study had several purposes. First, since the questions asked were not replicated from other studies, it was necessary to determine whether the bankers understood the meaning of each question and could easily answer it without confusion. Second, even though the case information and questionnaire were developed after consulting with local bankers, it was

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

important to determine whether any necessary information was missing. Finally, the pilot study would give the researcher an indication of the potential response rate for the main study which would help in planning the appropriate sample size. The sample size for the pilot study needed to be large enough to reach a representative sample of bankers yet small enough to fulfill the limited objectives of the pilot study. A sample of 100 was deemed appropriate.

To select a random sample from the database, each name and address was given a number. The total number of names and addresses were divided by 100 to obtain an interval. A random starting point was blindly selected from the first interval and every nth name and address thereafter was selected to reach a total sample size of 100. This method of systematic random sampling is widely used by auditors in selecting items such as accounts receivable for confirmation.

The selected bankers were then divided into two equal groups and mailed a sample case along with questions and a postage-paid return envelope. The respondent was asked to indicate the date when he completed this questionnaire. This date would serve later to test for any difference between early and late respondents. It was determined that using the date of completion was better than the date of mailing since different banks had different mailing systems and a letter could be mailed the following day or it could take up to a week for it to be mailed. This prediction was confirmed by comparing the noted date of completion to the postmark date on the return

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

envelope. It was found that many responses were mailed immediately while others took several days. Most of the responses were received within a two-week period after the initial mailing with a few received in the third and fourth weeks. Out of the total of 100 mailings, 15 return envelopes were received. Three respondents indicated that the bank did not have a commercial lending department and therefore were not able to provide a usable response. There were 12 usable responses, representing a usable response rate of 12%. They consisted of seven responses from the group that received the modified report and the footnote and five responses from the group receiving the unqualified report and the footnote. All respondents answered all the questions. In other words, no information was missing.

The information provided by the bankers was analyzed and it appeared that they fully understood the questions. Therefore, the pilot study fulfilled its three main objectives: the questions were understood, no necessary information was missing, and a predicted response rate was obtained.

The Main Study

After the pilot study was completed, it was determined that no changes were needed in the case or the questionnaire. Therefore, the main part of the study was initiated.

Assuming that the response rate in the main study would be similar to the one in the pilot study, a sample size of 2,100 was deemed appropriate. This sample would be large enough to provide meaningful statistical analysis.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Two mailings were conducted: the first mailing (consisting of 900 bankers) covered the Northeastern and Southeastern U.S. and the second mailing (consisting of 1,200 bankers) covered the rest of the country. A t test on the likelihood of granting the credit scale indicated no significant difference between the two mailings for the group receiving the modified report and the footnote ($t = -0.7$, $p = 0.47$) and for the group receiving the unqualified report and the footnote ($t = -0.21$, $p = 0.83$). The sample selection method was the same as the pilot study. Even though the database provided the names and addresses of the vice presidents for lending in these banks, the cover letter indicated that they could forward the case to another loan officer in their banks.

Most of the responses were received in the two-week period following the mailing, although a few were received up to four weeks later. A total of 290 responses were received representing a general response rate of 13.8%. The first mailing generated 130 responses of which 117 responses were usable. The usable response rate was 13%. The second mailing generated 160 responses of which 153 responses were usable. The usable response rate was 12.75%. Therefore, the main part of the study consisted of 270 responses representing a response rate of 12.85%.

The unusable responses were similar to the ones received in the pilot study. The bankers indicated that their banks were not involved in commercial lending, and therefore, the questionnaire was returned intact. Examining both

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

groups under consideration, 134 responses were returned from the group receiving the modified report and the footnote while 136 responses were returned from the group receiving the unqualified report and the footnote. Examining the postmark stamp on the return envelope, it was determined that the respondents were scattered across the country. Out of the 270 responses received, only eight contained partially missing information. For example, a questionnaire would be missing an interest rate or a confidence estimate. In analyzing the data, if a particular scale or interest rate were missing, the respondent was omitted from this particular analysis.

Test for Nonresponse Bias

A common consideration in survey studies is the impact of nonrespondents on the study's conclusions. If the nonrespondents represent a significant percentage, some concern exists that they have characteristics different from the respondents'.

A common technique used by researchers to test for nonresponse bias is to compare early respondents to late respondents to determine if their answers to the same question were different. This technique assumes that nonrespondents possess the same characteristics as late respondents. The null hypothesis in this case was that there was no difference between early and late respondents. This analysis was separately conducted on both groups of bankers. To determine early and late respondents, the date of completing the questionnaire was used. The whole period was divided in two periods and the

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

early and late respondents were identified. A t test was used to test for any difference between early and late respondents on the likelihood of granting the credit scale. The results are shown in Table 4.1.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

TABLE 4.1

COMPARISON OF EARLY AND LATE RESPONDENTS

Timing	Sample Size	Mean Scale	Std Dev	Std Error	T Value	Prob>T
Group receiving the modified report and footnote						
Early	70	2.35	1.52	0.18	-0.30	0.76
Late	68	2.43	1.43	0.17		
Group receiving the unqualified report and footnote						
Early	66	2.39	1.39	0.17	0.86	0.39
Late	69	2.20	1.17	0.14		

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Based on the T values of -0.30 and 0.86 and the corresponding P values of 0.76 and 0.39, the null hypothesis of no difference between early and late respondents could not be rejected at the 0.05 level of significance. This conclusion held true for the group receiving the modified report and the footnote disclosure and the group receiving the unqualified report and the footnote disclosure. Therefore, if nonrespondents possessed the same characteristics as late respondents, the results of this study would not be significantly different.

Research Results

After determining that potential nonresponse bias should not significantly affect the survey's results, the research investigated the different hypotheses. The group receiving the modified report and the footnote is referred to as "Group P & F." The group receiving the unqualified report and the footnote is referred to as "Group F."

Hypotheses Tests

The first hypothesis investigated whether the group receiving the modified report and the footnote would differ significantly in its likelihood of granting a line of credit from the group receiving the unqualified report and the footnote. This hypothesis was designed to measure risk perception, where the lower the likelihood of granting a line of credit, the higher the perception of risk. It is restated as follows:

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Hypothesis 1: Bankers' estimate of the likelihood of granting a line of credit to a given company based upon a modified going concern report and a footnote disclosure would not differ substantially from the estimate to the same company on the basis of an unqualified opinion and a footnote disclosure.

A t test was employed to test this hypothesis and the results are shown in Table 4.2.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

TABLE 4.2

COMPARISON OF BOTH GROUPS' LENDING ESTIMATE
(on a 1 to 7 scale)

Group	Sample Size	Mean Scale	Std Dev	Std Error	T Value	Prob > T
Group F	140	2.35	1.33	0.11	-0.38	0.69
Group P & F	141	2.42	1.47	0.12		

where:

Group F = Group receiving the unqualified report and the footnote

Group P & F = Group receiving the modified report and the footnote

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

The results revealed the following findings. First, for both groups, the mean likelihood of granting the line of credit was low. This meant that, in general, bankers were reluctant to recommend a line of credit to a company exhibiting going concern difficulty. Second, the difference between both groups was not statistically significant. Based on the T value of -0.38 and its corresponding P value of 0.69, the null hypothesis of no difference between the two groups in their lending estimate could not be rejected at the 0.05 level of significance. A sample of both groups' comments on the reasons for their estimate is provided in Appendix C.

The second hypothesis investigated whether both groups were significantly different in their interest rate estimate. It is restated as follows:

Hypothesis 2: The interest rate that bankers would charge for a line of credit to a given company based upon a modified going concern report and a footnote disclosure would not differ substantially from the interest rate the bankers would charge to the same company on the basis of an unqualified opinion and a footnote disclosure.

This hypothesis was similar to the first in that it measured risk where the higher the interest rate to charge the company, the higher the perception of risk. The results of the t test for equality of means are shown in Table 4.3.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

TABLE 4.3

COMPARISON OF BOTH GROUPS' INTEREST RATE ESTIMATE (above prime rate)

Group	Sample Size	Mean Rate	Std Dev	Std Error	T Value	Prob>T
Group F	139	2.48	0.88	0.07	-0.17	0.86
Group P & F	141	2.50	1.01	0.08		

where:

Group F = Group receiving the unqualified report and the footnote

Group P & F = Group receiving the modified report and the footnote

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

The results showed that the mean interest rate that would be charged to this company by both groups was about 2.5% above the prime rate. Based on the T value of -0.17 and its corresponding P value of 0.86, the null hypothesis of no difference between the two groups in their interest rate estimate could not be rejected at the 0.05 level of significance.

The third hypothesis tested for any difference between the two groups in their level of confidence in their estimates. Confidence in the estimate was a measure of any side effects of the explanatory paragraph. Confidence measured the quality of the lending decision where less confidence indicated lower quality for the decision. The hypothesis is restated as follows:

Hypothesis 3: Bankers' confidence in their lending estimate for a given company based upon a modified going concern report and a footnote disclosure would not differ substantially from their confidence for a line of credit to the same company on the basis of an unqualified opinion and a footnote disclosure.

The t test results are shown in Table 4.4.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

TABLE 4.4

COMPARISON OF BOTH GROUPS' CONFIDENCE
(on a 1 to 7 scale)

Group	Sample Size	Mean Scale	Std Dev	Std Error	T Value	Prob>T
Group F	139	5.86	1.28	0.10	0.92	0.35
Group P & F	141	5.72	1.25	0.10		

where:

Group F = Group receiving the unqualified report and the footnote

Group P & F = Group receiving the modified report and the footnote

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

The results showed that, in general, bankers felt confident in their lending estimate for the line of credit. Even though the group that received the unqualified report and the footnote was slightly more confident in its lending estimate than the group that received the modified report and the footnote, the difference was not statistically significant. Based on the T value of 0.92 and its corresponding P value of 0.35, the null hypothesis of no difference between the two groups in their confidence level could not be rejected at the 0.05 level of significance.

The fourth hypothesis tested for any difference in perception of bankruptcy between the two groups where a significantly higher estimate of bankruptcy by the group receiving the modified report and the footnote indicates information content attributable to the explanatory paragraph. It is restated as follows:

Hypothesis 4: Bankers' perception of bankruptcy likelihood for a given company based upon a modified going concern report and a footnote disclosure would not differ substantially from their perception about the same company on the basis of an unqualified opinion and a footnote disclosure.

The t test results are shown in Table 4.5.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

TABLE 4.5

COMPARISON OF BOTH GROUPS' BANKRUPTCY PERCEPTION (on a 1 to 7 scale)

Group	Sample Size	Mean Scale	Std Dev	Std Error	T Value	Prob>T
Group F	138	3.85	1.33	0.11	-0.99	0.31
Group P & F	139	4.01	1.31	0.11		

where:

Group F = Group receiving the unqualified report and the footnote

Group P & F = Group receiving the modified report and the footnote

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

These results showed that, in general, bankers had a neutral estimate of the likelihood that this company would declare bankruptcy in the next 12 months. In other words, in their view, the chance of bankruptcy was about equal to the chance of survival. Even though the group receiving the modified report and the footnote had a slightly higher perception of bankruptcy than the other group, this difference was not significant. Based on the T value of -0.99 and its corresponding P value of 0.31, the fourth hypothesis of no difference between the two groups in their perception of bankruptcy could not be rejected at the 0.05 level of significance.

Summary

The previous t-tests have investigated any difference between the group receiving the modified report and the footnote and the group receiving the unqualified report and the footnote. The results revealed that there was no statistical difference between these two groups on any of the scales or the interest rate estimate.

Ordinary Least Squares

In addition to the above statistical tests, OLS regression was used to investigate whether any of the demographic characteristics of lending officers or their banks had an impact on the estimates or the perceptions. In the first test, the likelihood of granting the line of credit estimate was the dependent

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

variable and the different demographic characteristics were the independent variables. The results are revealed in Table 4.6.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

TABLE 4.6

**EFFECT OF DEMOGRAPHIC CHARACTERISTICS
ON THE LENDING ESTIMATE
(280 observations)**

Param.	Estim.	T Value	Prob>T	F Value	Prob>F
Interc.	2.08	6.32	0.0001	0.80	0.55
Parag	0.08	0.52	0.60		
Exp	0.01	0.23	0.81		
Acc	0.10	1.49	0.13		
Audit	0.10	0.57	0.56		
Asset	-0.06	-1.03	0.30		

where:

Parag = The explanatory paragraph

Exp = Loan officers' experience

Acc = Loan officers' accounting education

Audit = Loan officers' audit education

Asset = Bank asset size

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Since there was no single explanatory variable that was statistically significantly different from zero at the 0.05 level, the null hypothesis that there was no relationship between the dependent variable and all of the suggested explanatory variables could not be rejected at the 0.05 level of significance. This meant that none of the demographic characteristics of the bankers or the banks had an impact on the likelihood of granting the line of credit.

The results of examining the potential impact of these same demographic characteristics on the bankers' estimate of the interest rate are shown in Table 4.7.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

TABLE 4.7

EFFECT OF DEMOGRAPHIC CHARACTERISTICS ON THE INTEREST RATE (above prime rate) (279 observations)

Param.	Estim.	T Value	Prob>T	F Value	Prob>F
Interc.	2.38	10.85	0.0001	2.13	0.06***
Parag	0.03	0.32	0.74		
Exp	0.10	2.49	0.013**		
Acc	-0.05	-1.17	0.24		
Audit	0.14	1.14	0.25		
Asset	-0.07	-1.70	0.08***		
** significant at the 0.05 level	*** significant at the .10 level				

where:

Parag = The explanatory paragraph

Exp = Loan officers' experience

Acc = Loan officers' accounting education

Audit = Loan officers' audit education

Asset = Bank asset size

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Among all the possible explanatory variables, experience as a loan officer attained statistical significance at the 0.05 level. With a positive coefficient estimate, this means that the more experience loan officers possessed, the higher the interest rate they would charge to a company. A possible explanation for this significance is that loan officers with more experience were better able to assess a company's risk profile in a lending recommendation because of their past dealings with similar companies. For a going concern situation, this assessment led to a higher risk profile which in turn led to a higher interest rate. In addition, bank assets was also significant at the .10 level. In this case, the higher the bank's assets, the lower the premium interest rate the bank would charge this company. A possible explanation is that larger banks, because of their standing in the industry, are better able to offer lower loan rates to risky customers than other smaller banks that can not afford this advantage to risky customers.

OLS regression was also used to measure the impact of the explanatory variables on bankers' confidence in their lending recommendation. The results are shown in Table 4.8.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

TABLE 4.8

EFFECT OF DEMOGRAPHIC CHARACTERISTICS ON BANKERS' CONFIDENCE (279 observations)

Param.	Estim.	T Value	Prob>T	F Value	Prob>F
Interc.	5.81	20.11	0.0001	1.10	0.29
Parag	-0.15	-1.02	0.30		
Exp	-0.004	-0.08	0.93		
Acc	-0.01	-0.20	0.84		
Audit	0.14	0.90	0.36		
Asset	0.02	0.49	0.62		

where:

Parag = The explanatory paragraph

Exp = Loan officers' experience

Acc = Loan officers' accounting education

Audit = Loan officers' audit education

Asset = Bank asset size

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

These results indicated that none of the explanatory variables was statistically significant at the .05 level. The null hypothesis that there is no relationship between the confidence level and the explanatory variables can not be rejected at the .05 level.

Regression analysis was finally used to investigate the potential impact of demographics on bankruptcy estimates for this company. The results are shown in Table 4.9.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

TABLE 4.9

EFFECT OF DEMOGRAPHIC CHARACTERISTICS ON BANKRUPTCY ESTIMATE (280 observations)

Param.	Estim.	T Value	Prob>T	F Value	Prob>F
Interc.	4.11	13.17	0.0001	1.46	0.22
Parag	0.19	1.19	0.23		
Exp	-0.10	-1.81	0.07***		
Acc	-0.002	-0.04	0.97		
Audit	0.16	0.93	0.35		
Asset	0.01	0.20	0.84		
*** significant at the .10 level					

where:

Parag = The explanatory paragraph

Exp = Loan officers' experience

Acc = Loan officers' accounting education

Audit = Loan officers' audit education

Asset = Bank asset size

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Among the possible explanatory variables, only experience attained significance at the .10 level. With a negative coefficient, this meant that the higher the bankers' experience, the lower their perception of bankruptcy. This could be attributed to the bankers' previous dealings with companies in similar financial situation that survived their troubled years.

The next step of the analysis involved investigating the relationship between the interest rate estimate and bankruptcy perception in both groups. It would seem plausible that the higher the perception of a company's bankruptcy, the higher its risk and therefore, the higher the interest rate that would be charged to such a company. OLS regression was used to investigate this relationship where the interest rate estimate was the dependent variable and bankruptcy perception and the explanatory paragraph were the independent variables. The results are shown in Table 4.10.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

TABLE 4.10

EFFECT OF BANKRUPTCY PERCEPTION ON THE INTEREST RATE (above prime rate) (279 observations)

Param.	Estim.	T Value	Prob>T	F Value	Prob>F
Interc.	1.91	10.84	0.0001	6.77	0.0013*
Bankr.	0.15	3.68	0.0003*		
Parag.	-0.025	-0.23	0.81		
* significant at the .01 level					

where:

Bankr = Estimate of company's bankruptcy scale

Parag = the explanatory paragraph (1 if received modified report, 0 otherwise)

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

These results indicated there was a statistically significant relationship between bankruptcy perception and the interest rate at the .01 level of significance. The higher the company's bankruptcy perception, the higher the interest rate that bankers would charge to this company. The explanatory paragraph did not have a statistically significant impact on the interest rate.

Nonparametric Tests

The parametric tests employed assumed that the population of bankers was normally distributed. Nonparametric tests, on the other hand, do not require such a restrictive assumption. The Kolmogorov-Smirnov (KS) two-sample test requires only that the samples be randomly selected and be mutually independent.

The KS test involved determining the maximum absolute difference between the two-samples cumulative distribution functions. This maximum difference was then compared to the tabulated difference.

The KS test of the hypothesis of no difference in the lending recommendation between the two groups showed that the calculated maximum difference was 0.05. If the significance level was set at 0.10 for a two-tailed test, the tabulated difference was 0.21. Since the calculated difference was less than the tabulated difference, the null hypothesis of no difference between the cumulative distribution functions of the two populations of bankers could not be rejected at the 0.10 level of significance.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

The KS test of the hypothesis of no difference between confidence levels of both groups of bankers produced a calculated difference of 0.12. If the significance level was set at 0.10 for a two-tailed test, the tabulated difference was 0.21. Because the calculated difference was less than the tabulated difference, the null hypothesis of no difference between the distribution functions of both populations of bankers in their confidence level could not be rejected at the 0.10 level of significance.

The KS test of the hypothesis of no difference between both groups in their bankruptcy estimate produced a calculated difference of 0.07. Setting the significance level at 0.10 for a two-tailed test, the tabulated difference was 0.21. Because the calculated difference was less than the tabulated difference, the null hypothesis of no difference between the two distribution functions of bankers in their bankruptcy estimate could not be rejected at the 0.10 level of significance.

Relaxing the assumption of a normally distributed population and assuming that the Likert scale was an ordinal scale, the non-parametric KS test failed to reject the first, third and fourth hypotheses set forth in Chapter 2. The KS test is exact if the measurement scale is continuous and produces slightly conservative results if the scale is discrete. According to Conover (1980), this means that the tabulated difference with a discrete scale may be slightly less than the tabulated difference with a continuous scale. However, since all calculated values were substantially less than the tabulated values, the

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

test results would still be valid and the three hypotheses still would not be rejected.

Summary

This chapter presented the data collection procedures, analysis and results. It began with a discussion of the purpose and the execution of the pilot study which was followed by the main study. The possibility of nonresponse bias was examined by comparing early and late respondents. Next, the chapter discussed hypotheses tests. Parametric and nonparametric tests were applied to the data. Each hypothesis was tested to reject it or fail to reject it. The results showed no difference between the two groups of bankers on any of the scales or the interest rate estimate. The results also showed that experience positively affected the interest rate estimate and that bank assets negatively affected the interest rate estimate. In addition, experience negatively affected the bankers' perception of this company's bankruptcy. There was also a statistically significant positive relationship between interest rate estimate and bankruptcy estimate for the group receiving the unqualified report and the footnote and a significant positive relationship between these two estimates for the group receiving the modified report and the footnote. The following chapter discusses the study's conclusions and the policy implications of its findings. It also notes the limitations and provides suggestions for future research.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

CHAPTER 5

DISCUSSION AND IMPLICATIONS OF FINDINGS

This chapter discusses the research's findings. It compares these results to previous empirical results in terms of agreement or disagreement. The chapter also discusses the implications of these findings on policy making in the auditing and banking professions. In addition, it notes the limitations of this research which should be considered when interpreting its results or drawing conclusions. Finally, it offers possible avenues for future research that would allow drawing more concrete conclusions on the impact of the going concern opinion on different users of the financial statements.

Discussion of Findings

This research had several major and secondary objectives. The major general objective was to investigate the impact of the going concern modified audit report on credit granting decisions by commercial loan officers. This general objective was achieved by searching for any information content attributable to the explanatory paragraph. Information content was determined to exist if two groups of bankers reached different conclusions about a

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

particular company based on a modified audit report with an explanatory paragraph and footnote disclosure of the going concern uncertainty compared to an unqualified opinion and the footnote disclosure. Bankers had to estimate the likelihood that a line of credit would be granted, their confidence in this estimate, the interest rate to charge this company on the line of credit, and their perception of this company's bankruptcy status. These estimates and perceptions served as means of detecting any information content of the explanatory paragraph.

Secondary objectives of this study included gaining insight into lenders' reaction to a company exhibiting going concern difficulty. For example, were demographic characteristics such as experience, accounting and audit education and bank asset size significant determinants of any of the estimates or perceptions? These possible determinants could have implications to companies exhibiting going concern difficulties in their search for a loan. The following sections discuss the findings.

Likelihood of Granting Credit

It was hypothesized that the two groups of bankers would make the same estimate of granting a line of credit for this company regardless of the method of reporting going concern uncertainty. The results did not support a rejection of this hypothesis. Therefore, reporting going concern doubt in the

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

audit report does not appear to influence bankers' decision and does not have statistically significant information content.

This conclusion was reinforced by examining bankers' reasons for their estimate (See Appendix C). Among all the factors cited, the most common factors for both groups were negative working capital, the company's dependence on one customer and the company's earnings history. These factors were listed in the explanatory paragraph. However, the fact that these items were noted by the bankers who received only the footnote disclosure indicates that the going concern footnote provides sufficient explanation of the going concern problem. For the group receiving the modified report and the footnote it appeared that of the 141 responses received, only 15 bankers noted the modified report as a factor in their lending estimate, reinforcing the same conclusion. In fact, some even wrote "going concern qualification", incorrectly referring to the modified report, an act that indicated that they did not perceive the opinion as an unqualified opinion.

These results agreed with the CAR's (1978) conclusions that restating footnote information in the audit report was at best redundant and did not serve a useful purpose. The results also agreed with the ASB's own logic in issuing SAS NO. 79 related to other uncertainties. From an academic point of view, they agreed with the following studies: Estes and Reimer (1977), Libby (1979b), Abdel-Khalik, Graul and Newton (1986) and Pringle, Crum and Swetz (1990). However, these results disagreed with Bamber and Stratton (1997) who

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

found information content attributable to the modified report due to other uncertainties and the other studies conducted outside the U.S.

In addition to finding no information content in the explanatory paragraph, it was noted that the likelihood of granting credit to a going concern company was low. Based on the Likert scale used in this study, granting a line of credit was very unlikely. This result agreed with LaSalle and Anandarajan (1997) who found that bankers were unwilling to consider a loan to companies with going concern problems.

Interest Rate Estimate

The interest rate estimate also served to measure risk. It was hypothesized that both groups of bankers would be similar in their interest rate determination. The results did not support a rejection of this hypothesis. It was found that bankers assigned the same rate (approximately 2.5% above the prime rate) to the company regardless of the method of reporting going concern uncertainty. The explanatory paragraph, therefore, appears to have no information content. This result agreed with Libby (1979b) and Abdel-Khalik, Graul and Newton (1986). These studies also did not find an interest rate difference in loans which bankers would grant to companies based on a qualified opinion with a footnote and only a footnote disclosure. The results disagreed with Bamber and Stratton (1997) who found a significant interest rate difference due to a modified report for other uncertainties. The results also disagreed with Gul's (1987) results in Singapore.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Confidence in Lending Estimate

It was hypothesized that bankers' confidence in a lending estimate would not differ significantly based on the method of reporting going concern uncertainty. This hypothesis was designed to measure the quality of the lending decision. The results did not support a rejection of this hypothesis. Based on the Likert scale, bankers were on average very confident in their lending decision. These two estimates, the unlikelihood of making a loan and their confidence in that decision, taken together reinforced LaSalle and Anandarajan's (1997) study that bankers were reluctant to offer credit to a company with going concern uncertainty. The results also did not reveal confusion due to the explanatory paragraph in an unqualified opinion as noted by Pringle, Crum, and Swetz (1990).

Bankruptcy Prediction

It was hypothesized that bankruptcy perception for the same company would be similar regardless of the reporting method. The results did not support a rejection of this hypothesis. Both groups of bankers assessed the same bankruptcy likelihood to this company. Even though the explanatory paragraph, apparently, did not have information content, other results appeared. Surprisingly, bankers viewed the likelihood of bankruptcy as neutral. On a Likert scale, this meant the company was as likely to declare bankruptcy as to survive. In its recommendation to eliminate the going concern modification, the CAR (1978) noted that users viewed these

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

modifications as prediction of bankruptcy. This study did not find that particular effect.

Demographic Characteristics

This study found that experience as a loan officer had a significant positive impact on the interest rate to charge a company exhibiting going concern difficulty. This finding agreed with Keyes (1978) and Rodgers and Housel's (1987) studies that found demographic characteristics to be significant in the loan decision. In addition, larger banks would have charged a lower interest rate premium to this company compared to smaller banks. This could be attributed to larger banks settling for a lower return on their investment while smaller banks, being more risk averse, would require a larger return on their investment. Experience also negatively affected bankruptcy estimates, possibly due to past dealings with similar troubled companies that eventually survived.

Implications of Findings

This study investigated the information content of the going concern explanatory paragraph in the modified audit report. The ASB requires the auditor to positively assess going concern uncertainty in every audit and, if doubt exists, to add an explanatory paragraph to the audit report. However, previous research by different committees, as well as academic research, often has concluded that the information contained in the paragraph is redundant.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

The current study confirmed these conclusions. When faced with a double signal regarding going concern uncertainty (explanatory paragraph and footnote), bankers did not behave differently than when faced with only one signal in the footnote.

This study's results should be useful to the ASB in its policy making efforts. Even though adequate and appropriate disclosure is in the best interest of all users, redundant information should be avoided. The ASB took the correct step in eliminating the explanatory paragraph requirement for other uncertainties and should seriously consider doing the same for going concern uncertainty.

Limitations of the Study

The conclusions of this study should be interpreted with the following limitations, that may or may not affect the generalizability of the results. First, even though the study's response rate of 13% was adequate for the statistical tests employed, and nonresponse bias was not detected, the possibility always exists that nonrespondents could have provided different answers that would have changed the result. This limitation, however, is common to all surveys.

Second, bankers receiving the modified report and the footnote disclosure of going concern uncertainty were faced with the standard reporting practice for this situation, a practice with which they were familiar. However, the other group received an unqualified audit report with no reference to going concern uncertainty and a footnote disclosure, a reporting practice with which

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

they were not familiar. The artificial nature of this situation should be taken into consideration in interpreting the results.

Finally, the study's conclusions may or may not be generalized to other companies exhibiting going concern uncertainty. Care was taken to choose a company exhibiting borderline going concern characteristics to avoid extreme answers. Based on respondents' bankruptcy estimate, this proved to be true. However, bankers' reaction to other companies with more or less severe going concern characteristics may be different.

Suggestions for Future Research

Reporting going concern difficulty has been a controversial issue for the ASB, auditors and users. This study investigated bankers' reaction to the current method of reporting compared to a method not currently used. Future research could address two important issues. First, it should investigate other users' (such as bondholders, stockholders and financial analysts) reaction to the going concern explanatory paragraph. If the same results were found, it would strengthen the argument of eliminating the going concern modification in the audit report. Second, since SAS No. 59 was issued in 1988, it is important to measure users' preference for the method of reporting going concern uncertainty ten years later. Therefore, a descriptive study could be conducted, especially since the report modification requirement for other uncertainties was eliminated by the issuance of SAS No. 79 in 1995.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

APPENDIX A

CASE STUDY AND QUESTIONNAIRE

(Audit report contains the explanatory paragraph)

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

The lending decision is a continuing concern for members of the banking community, the accounting profession, and academia. Questions have arisen concerning the **amount** and **type** of information communicated to users of the financial statements, especially bankers.

I am a doctoral candidate in accounting at Louisiana Tech University and am conducting a study to determine **a company's risk profile in a lending decision.** This risk will be measured based on loan officers' reaction to selected information included in this company's annual report.

You have probably been asked in the past to participate in studies concerning corporate financial reporting. These requests can become burdensome; yet only through the help of experts like yourself can the quality of this information be improved. If you feel that somebody else in your bank may be more interested in completing this survey, please forward it to him/her.

Please find enclosed selected information from a company's annual report to use in a lending decision. Obviously, corporate lending decisions are based on a great deal of information beyond that provided here for this company. However, it was necessary that the information package be limited to that enclosed due to your time constraints. May I ask **10-20 minutes** of your time to review the enclosed information and answer a few questions? You can be assured of complete confidentiality. Your bank's name will never be placed on the research instrument nor will any respondent be individually identified. Your help will be sincerely appreciated and will hopefully contribute to improvements in financial reporting.

Sincerely,

Rafik Z. Elias
DBA Candidate in Accounting

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

The data provided consists of:

(1) Information about the company and its business
(2) An audit report
(3) Condensed financial statements
(4) 3 Footnotes

After reading this information, the questions will ask you to predict the likelihood that this company will be granted **a one-year secured working capital line of credit in the range of $750,000 - $1 million** and the appropriate interest rate.

DESCRIPTION OF BUSINESS

Started in 1976, ABC, Inc. is engaged through its wholly owned subsidiary, Sub., Inc. in manufacturing and distributing cosmetics and other beauty products and providing facial and other beauty services. Products and services are sold in better department stores and specialty stores in the U.S. and Canada. In 1995, Sub., began selling specialty cosmetic products through television marketing.

OTHER INFORMATION

Number of outstanding shares: 11,612,926

Shares held by officers and directors: 8,188,935 (70% of total)

Number of shareholders: 2,519

Close(or average) price for the stock: $1.375

Exchange: American Stock Exchange

Market value(000s): $15,909

Annual dividends: 0

Number of employees: 118

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

3-YEAR FINANCIAL SUMMARY(000'S)

	July 31, 1996	*July 31, 1995*	*July 31, 1994*
Cash	516	10	1,134
Receivables	1,392	2,689	1,444
Inventories	3,327	2,553	3,766
Other Current Assets	29	282	268
TOTAL CURRENT ASSETS	**5,264**	**5,535**	**6,611**
Property, Plant & Equipment	7,351	7,949	8,182
Accumulated Depreciation	5,622	5,093	4,342
Net Property, Plant & Equipment	1,729	2,856	3,840
Intangibles	3,625	3,795	3,965
Deposits & Other Assets	138	176	198
TOTAL ASSETS	**10,756**	**12,362**	**14,615**
Accounts Payable	3,106	3,789	3,343
Current Long-Term Debt	2,863	5,421	7,641
Accrued Expenses	1,924	2,230	2,461
TOTAL CURRENT LIABILITIES	**7,893**	**11,440**	**13,445**
Long-Term Debt	725	149	149
Other Long-Term Liabilities			120
TOTAL LIABILITIES	**8,618**	**11,589**	**13,714**
Common Stock(Net)	115	114	103
Preferred Stock	750	750	750
Capital Surplus	12,630	12,522	11,234
Retained Earnings	(11,357)	(12,613)	(11,186)
TOTAL STOCKHOLDERS' EQUITY	**2,138**	**774**	**901**
TOTAL LIABILITIES & EQUITY	**10,756**	**12,362**	**14,615**
Net Sales	32,151	29,358	34,764
Cost Of Goods Sold	9,292	7,651	13,035
GROSS PROFIT	**22,859**	**21,707**	**21,729**
Selling, General & Administrative Expenses	20,899	22,631	29,284
OPERATING INCOME(LOSS)	**1,960**	**(924)**	**(7,554)**
Interest Expenses	440	461	1,508
Other Expenses	21	42	677
Income Before Taxes	1,499	(1,427)	(6,723)
NET INCOME(LOSS)	**1,365**	**(1,427)**	**(6,723)**
Shares Outstanding	11,519	11,403	10,272
Net Income	1,365	(1,427)	(6,722)
Depreciation/Amortization	1,491	1,136	1,001
Net Increase/Decrease Assets/Liabilities	(174)	69	5,829
Other Adjustments(Net)	192	212	(1,754)
NET CASH PROVIDED(USED) BY OPERATING ACTIV	**2,874**	**(10)**	**(1,646)**
Net Increase(Decrease) in Property, Plant & Equipment	(387)	(193)	(81)
Acquisition(disposition) of subs, business			1799
NET CASH PROVIDED(USED) BY INVESTING ACTIVI	**(387)**	**(193)**	**1,718**
Increase(Decrease) in Borrowings	(1,981)	(1,957)	(2,327)
Issue(Purchase) of Equity			3,300
Other Cash Inflow		1,036	
NET CASH PROVIDED(USED) BY FINANCING ACTIVI	**(1,981)**	**(921)**	**973**
NET CHANGE IN CASH AND CASH EQUIVALENTS	**506**	**(1,124)**	**1,045**

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

AUDIT REPORT BY A "BIG SIX" FIRM

We have audited the accompanying consolidated balance sheets of ABC, Inc.(a New York corporation) and subsidiaries as of July 31, 1996 and 1995, and the related consolidated statements of operations, shareholders' equity and cash flows for each of the three years in the period ended July 31, 1996. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made my management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects the financial position of ABC, Inc. and subsidiaries as of July 31, 1996 and 1995, and the results of their operations and their cash flows for each of the three years in the period ended July 31, 1996, in conformity with generally accepted accounting principles.

The accompanying financial statements have been prepared assuming that the company will continue as a going concern. As discussed in Note 3 to the financial statements, the fiscal year ended July 31, 1996 is the first profitable year of operations in five years; however, the company maintains a working capital deficit at July 31, 1996 and is significantly dependent upon one customer. These factors discussed in Note 3 raise substantial doubt about the company's ability to continue as a going concern. Management's plans in regard to these matters are also described in Note 3. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

FOOTNOTES TO THE FINANCIAL STATEMENTS

NOTE 1: SIGNIFICANT ACCOUNTING POLICIES:

All significant intercompany transactions and accounts have been eliminated in consolidation. Inventories are stated at the lower of cost or market. Cost is determined using the first-in, first-out method. Property, plant and equipment are stated at cost and depreciated using the straight-line method over their estimated useful lives ranging from 4 to 15 years.

NOTE 2: DEBTS OUTSTANDING:

LONG-TERM DEBT:

	1996	1995
Term promissory note (please see (1) below)	$1,025,000	$1,325,000
Term loan (please see (2) below)	2,500,00	3,741,233
Related party loans	34,826	300,000
Notes payable(construction)	28,019	202,993
	3,587,845	5,569,226
Less, current portion	(2,862,845)	(5,420,644)
Long-term notes payable	725,000	148,582

(1) Note is collaterized by a distribution and administration facility. Interest is 2% above the bank's prime lending rate(8.75% and 7.25% at July 31, 1996 and 1995 respectively). Principal payments of $25,000 are due each month until Dec. 1999.

(2) Interest is .5% above the bank's prime lending rate. Financial covenants at July 31, 1996 require the company to have consolidated tangible net worth of not less than $2,250,000 and capital expenditures not to exceed $400,000. The

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

company was in compliance. For the year ending July 31, 1997, consolidated net worth should be no less than $1 million.

NOTE 3: GOING CONCERN:

During the fiscal year ended July 31, 1996, the company began to realize the results of its restructuring efforts which have been occurring over the last three fiscal years. Over this period of time, the company reduced staff levels, implemented cost reduction programs and was successful in restructuring its debt facilities into longer more manageable terms. These factors combined with the success of the sales of Sub. products through the Home Shopping Network(HSN) has resulted in the company recording profits of $1,364,646 for the fiscal year ended July 31, 1996. This is the first profitable year for the company since the fiscal year ended July 1990. However, the company still maintains negative working capital of $2,629,154 and is currently significantly dependent upon one customer, and must meet a tangible net worth covenant of $1 million by July 31, 1997. During the fiscal year ended July 31, 1996 HSN was responsible for 48% of net sales. The prior years' losses combined with the demands of reducing large debt levels limited the company's ability to provide inventory to its customers, in adequate supply, on a consistent basis.

The current year's profitability and positive cash flow from operations have enabled the company to minimize its out-of-stock inventory situation. During the latter part of fiscal year 1996, the company also decided to suspend its distribution of fragrance products. The company can now concentrate its efforts and available cash flow toward attaining inventory levels in the skin care and cosmetic products distributed by Sub. which are more closely matched with manufacturing lead times and customer demands. During fiscal 1997, the company plans to invest in the refixturing and updating of its facial salons and counters at department store locations. The fiscal 1996 selling, general and administrative expenses include a $500,000 charge which reflects the acceleration of depreciation on older outdated salon equipment, furniture and fixtures. There has been increased interest in the Sub. product line due to the success of the sale of products through HSN. In addition to being able to provide the customer with a full line of skin care products, the company wants to maintain and enhance its image as a provider of quality skin care services. The company is seeking a buyer for the Y Trademark and investigating opportunities to sell and distribute the Sub. product line outside of its current U.S. and Canadian markets.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

QUESTIONNAIRE

Please answer the following questions. Your help is greatly appreciated.

Assume that this company is a new customer applying to your bank for a **one-year working capital line of credit in the range of $750,000 - $1 million.** It will be **secured** by the company's accounts receivable and inventory.

1. Based on the information presented in this case, please estimate the likelihood, on a scale of 1 to 7, that this line of credit will be granted. (circle one)

1-------2-------3-------4-------5-------6-------7
(highly unlikely) (highly likely)

2. What were the major factors influencing the decision relative to the granting of this line of credit?

3. On a scale of 1 to 7, please indicate your level of confidence in your previous estimate.(circle one)

1-------2-------3-------4-------5--------6-------7
(minimum confidence) (maximum confidence)

3. Regardless of the previous answers, please indicate your best estimate of the interest rate to charge this company on this line of credit, assuming that your bank uses the Wall Street Journal published prime rate and that it is currently 8.25%

8.25% + ________ %

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

4. On a scale of 1 to 7, please indicate your best estimate that this company will be bankrupt *in the next 12 months*. (circle one)

1-------2-------3-------4-------5-------6-------7
(highly unlikely) (highly likely)

5. Approximately, how many years of lending experience do you have?(including experience in reviewing loan applications) (check one)

_____ less than 5 _____ 5-10 ______ 11-15

_____ 16-20 _____ more than 20

6. Approximately, how many university-level accounting courses have you taken?(check one)

_____ less than 2 _____ 2-3 ______ 4-5

_____ 6-7 _____ more than 7

7. Have you had at least one auditing course? _____Yes _____No

8. Please indicate the appropriate range of your bank's assets:

_________ $100 - $299.9 Million
_________ $300 - $499.9 Million
_________ $500 - $999.9 Million
_________ $1 - 4.9 Billion
_________ $5 Billion Plus

9. Please write today's date

____

Please detach the two pages containing the questions and mail them back in the enclosed envelope. If you would like to receive a copy of this study's results, please enclose your name and address on a **separate** sheet of paper or a business card in the envelope.

Thank you very much for your cooperation.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

APPENDIX B

CASE STUDY AND QUESTIONNAIRE SAME AS APPENDIX A

(Audit report without the explanatory paragraph)

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

AUDIT REPORT BY A "BIG SIX" FIRM

We have audited the accompanying consolidated balance sheets of ABC, Inc.(a New York corporation) and subsidiaries as of July 31, 1996 and 1995, and the related consolidated statements of operations, shareholders' equity and cash flows for each of the three years in the period ended July 31, 1996. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made my management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects the financial position of ABC, Inc. and subsidiaries as of July 31, 1996 and 1995, and the results of their operations and their cash flows for each of the three years in the period ended July 31, 1996, in conformity with generally accepted accounting principles.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

APPENDIX C

SAMPLE OF RESPONDENTS' COMMENTS

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

RESPONSES FROM THE GROUP RECEIVING THE MODIFIED REPORT AND THE FOOTNOTE DISCLOSURE

Positive Factors

1. Profitable operations this year
2. New avenues for growth-Television Marketing
3. Focusing on best product seller

Negative Factors

1. Poor earnings performance
2. Highly leveraged
3. Undercapitalized
4. Dependent on one customer
5. Going concern qualification
6. Only one year of profitability
7. Negative working capital
8. Need to see results of other changes in operations

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

RESPONSES FROM THE GROUP RECEIVING ONLY THE FOOTNOTE DISCLOSURE

Positive Factors

1. Current liabilities and total liabilities are decreasing

2. Gross profit and net income are increasing

3. Steps are being taken to turn the company around and improve financial health

Negative Factors

1. Only one year of profitability

2. Weak liquidity

3. Collateral is inventory dependent

4. Sales dependent on one customer

5. Negative net worth

6. Highly leveraged

7. High operating expenses(mismanagement)

8. Negative cash flows after debt amortization

9. High intangible assets

10. Unstable market, likelihood of low quality accounts receivable

11. Negative working capital

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

REFERENCES

Abbott, Joann. 1994. Accountants' Precarious Perch. *The Practical Accountant* (January): 36-42.

Abdel-Khalik, A. Rashad, Paul R. Graul, and James D. Newton. 1986. Reporting Uncertainty and Assessment of Risk: Replication and Extension in a Canadian Setting. *Journal of Accounting Research* (Autumn): 372-382.

AICPA. 1942. Statement on Auditing Procedures No. 15. New York: AICPA.

_____. 1963. Statement on Auditing Procedures No. 33. New York: AICPA.

_____. 1981. The Auditor's Consideration When a Question Arises about an Entity's Continued Existence. SAS No. 34. (March). New York: AICPA.

_____. 1988. The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern. SAS No. 59. (April). New York: AICPA.

_____. 1989. Reports on Audited Financial Statements. SAS No. 58. (June). New York: AICPA.

_____. 1995. Amendment to Statement on Auditing Standards No. 58, Reports on Audited Financial Statements. SAS No. 79. (December). New York: AICPA.

Alderman, Wayne C. 1977. The role of uncertainty qualifications: Evidence to support the tentative conclusions of the Cohen's Commission. *Journal of Accountancy* (November): 97-100.

Alix, Jay and Elmer Heupel. 1990. Predicting business failures: let the lender beware. *The Journal of Commercial Bank Lending* (April): 54-60.

Altman, E.I. and T. McGough. 1974. Evaluation of a company as a going concern. *Journal of Accountancy* (December): 51-57.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Ameen, Elsie C., Kam Chan, and Daryl M. Guffey. 1994. Information content of qualified audit opinions for over-the-counter firms. *Journal of Business Finance and Accounting* (October): 997-1011.

Anandarajan, Asokan. 1995. A Comparison of the Disclaimer and Unqualified Modified Report: User Perception and Auditor Choice. Ph.D. Dissertation, Drexel University.

Anandarajan, Asokan and Henry R. Jaenicke. 1995. How auditors' reporting choices influence loan officers' decisions. *The Journal of Commercial Lending* (May): 55-59.

Anderson, Norman A. 1980. Scales and statistics: Parametric and nonparametric. *Psychological Bulletin* Vol. 58 (4): 315-316.

Arens, Alvin A. and James K. Loebbecke. 1988. Auditing: An Integrated Approach. Prentice Hall, Inc. Englewood Cliffs, New Jersey.

Asare, Stephen. 1990. The auditor's going-concern decision: a review and implications for future research. *Journal of Accounting Literature*.9: 39-64.

Bailey, William T. 1982. An appraisal of research designs used to investigate the information content of audit reports. *The Accounting Review* (January): 141-146.

Bamber, Michael E. and Richard A. Stratton. 1997. The information content of the uncertainty-modified audit report: Evidence from bank loan officers. *Accounting Horizons* (June): 1-11.

Banks, Doyle W. and William R. Kinney, Jr. 1982. Loss continency reports and stock prices: an empirical study. *Journal of Accounting Research* (Spring): 240-254.

Bell, Timothy B. and Arnold M. Wright. 1995. Auditing Practice, Research, and Education. A Productive Collaboration. New York: AICPA.

Beranek, William and Gadis J. Dillon. 1982. Consolidated financial statements: sufficient for loan decisions? *The Journal of Commercial Bank Lending* (October): 71-76.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Berthold, Richard H. 1979. Discussion of the impact of uncertainty reporting on the loan decision. *Journal of Accounting Research* (Supplement): 58-63.

Campbell, Jane E. and Jane F. Mutchler. 1988. The "Expectations Gap" and going-concern uncertainties. *Accounting Horizons.* March: 42-49.

CAR (Commission on Auditors' Responsibilities). 1978. Report, Conclusions and Recommendations. New York: AICPA.

Carmichael, D.R. and Kurt Pany. 1993. The expectation gap standards: progress, implementation issues, research opportunities. Proceedings of the expectation gap roundtable. (May). Charleston, South Carolina.

Carsello, Joseph V., Dana R. Hermanson, and H.Fenwick Huss. 1997. The effect of SAS No. 59: How treatment of the transition period influences results. *Auditing: A Journal of Practice and Theory* (Spring): 114-123.

_____. 1995. Temporal changes in bankruptcy-related reporting. *Auditing: A Journal of Practice and Theory* (Fall): 133-143.

Carsello, Joseph V. and Zoe-Vanna Palmrose. 1994. Auditor litigation and modified reporting on bankrupt clients. *Journal of Accounting Research* (Supplement): 1-29.

Chen, Kevin C. and Bryan K. Church. 1996. Going concern opinions and the market's reaction to bankruptcy filings. *The Accounting Review* (January): 117-128.

Choi, Sung K. and Debra C. Jeter. 1992. The effects of qualified audit opinions on earnings response coefficients. *Journal of Accounting and Economics* 15: 229-247.

Chow, Chee W. and Steven J. Rice. 1982. Qualified audit opinions and auditor switching. *The Accounting Review* (April): 326-335.

Citron, David B. and Richard J. Taffler. 1992. The audit report under going concern uncertainties: An empirical analysis. *Accounting and Business Research* (Autumn): 337-345.

Compact Disclosures. October 1996.

Conover, W.J. 1980. Practical Nonparametric statistics. John Wiley and Sons: New York, NY.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Craswell, A.T. 1988. The association between qualified opinions and auditor switches. *Accounting and Business Research* (Winter): 23-31.

_____. 1985. Studies of the information content of qualified audit reports. *Journal of Business Finance and Accounting* (Spring): 93-115.

Daniel, Wayne W. and James C. Terrell. 1989. Business Statistics. Houghton Mifflin Company. Boston, Massachussets.

Dodd, Peter, Nicholas Dopuch, and Robert Leftwitch. 1984. Qualified audit opinions and stock prices. *Journal of Accounting and Economics* 6: 3-38.

Dopuch, Nicholas, Robert W. Holthausen, and Richard W. Leftwich. 1986. Abnormal stock returns associated with media disclosures of 'subject to" qualified audit opinions. *Journal of Accounting and Economics* 8: 93-117.

Ellingsen, John E., Kurt Pany, and Peg Fagan. 1989. SAS No. 59: How to evaluate going concern. *Journal of Accountancy* (January): 51-57.

Elliott, John A. 1982. "Subject to" audit opinions and abnormal security returns-outcomes and ambiguities. *Journal of Accounting Research* (Autumn): 617-637.

Elliott, Robert K. and Peter D. Jacobson. 1987. The auditor's standard report: the last word or in need of change? *Journal of Accountancy* (February): 72-78.

Emory, C. William and Donald R. Cooper. 1991. Business Research Methods. Irwin: Homewood, IL

Estes, Ralph and Marvin Reimer. 1979. An experimental study of the differential effect of standard and qualified auditors' opinions on investors' price decisions. *Accounting and Business Research* (Spring): 157-161.

_____. 1977. A study of the effect of qualified auditors' opinions on bankers' lending decisions. *Accounting and Business Research* (Autumn): 250-259.

Fandit, Patricia M. and Gerald R. Ferris. 1990. The Management of Information and Impressions: When Employees Behave Opportunistically. *Organizational Behavior and Human Decision Processes* 45: 140-158.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Firth, Michael. 1980. A note on the impact of audit qualifications on lending and credit decisions. *Journal of banking and Finance* 4: 257-267.

_____. 1979. Qualified audit reports and bank lending decisions. *Journal of Bank Research* (Winter): 237-241.

_____. 1978. Qualified audit reports: their impact on investment decisions. *The Accounting Review* (July): 642-650.

Fleak, Sandra K. and Earl R. Wilson. 1994. The incremental information content of the going-concern audit opinion. *Journal of Accounting, Auditing and Finance* (Winter): 149-169.

Frost, Carol A. 1994. Uncertainty-modified audit reports and future earnings. *Auditing: A Journal of Practice and Theory* (Spring): 22-35.

Fulmer, John G., Thomas A. Gavin, and William J. Bertin. 1992. How commercial lenders evaluate your loan. *The Small Business Controller* (Summer): 35-38.

Garsombke, H. Perrin and Seungmook Choi. 1992. The association between auditors' uncertainty opinions and business failures. *Advances in Accounting* 10: 45-60.

Gul, Ferdinand. 1987. The effects of uncertainty reporting on lending officers' perceptions of risk and additional information required. *ABACUS* 23: 172-181.

_____. 1984. The joint and moderating role of personality and cognitive style on decision making. *The Accounting Review* (April): 264-276.

Guy, D.M. and J.D. Sullivan. 1988. The expectation gap auditing standards. *Journal of Accountancy* (April): 36-46.

Hillestad, Mildred. 1977. Research: Process and product. Delta Pi Epsilon. Service Bulletin No. 1.

Holt, Graham and Peter Moizer. 1990. The meaning of audit reports. *Accounting and Business Research* 20: 111-121.

Hopwood, William, James McKeown, and Jane Mutchler. 1989. A test of the incremental explanatory power of opinions qualified for consistency and uncertainty. *The Accounting Review* (January): 28-48.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Houghton, Keith A. and William F. Messier, Jr. 1991. The wording of audit reports: its impact on the meaning of the message communicated. *Accounting Communication and Monitoring*: 85-106.

_____. 1991. Reply to discussant's comments on:"The wording of audit reports: its impact on the message communicated." *Accounting Communication and Monitoring:* 115-116.

Houghton, Keith A. 1983. Audit reports: their impact on the loan decision process and outcome: an experiment. *Accounting and Business Research* (Winter): 15-20.

Johnson, Van E. and Inder K. Khurana. 1995. Auditor reporting for bankrupt companies: evidence on the impact of SAS No. 59. *Research in Accounting Regulations* 9: 3-22.

_____. 1993. Companies in trouble: what are the auditor's responsibilities? *The Journal of Commercial lending* (December): 53-57.

Kaplan, Steven and Kurt Pany. 1992. A study of public comment letters on the auditor's consideration of the going concern issue (SAS 59). *Research in Accounting Regulation* 6: 3-23.

Kemp, Robert S., Jr. and George A. Overstreet, Jr. 1990. A study of the information needs of commercial loan officers. *The Journal of Commercial Bank Lending* (February): 47-57.

Keys, David E. 1978. Confidence interval financial statements: An empirical investigation. *Journal of Accounting Research* (Autumn): 389-399.

Kinney, William R., Jr. 1986. Empirical accounting research design for Ph.D. students. *The Accounting Review* (April): 338-350.

Koenigsberg, Richard L. and Jill A. Blumenfeld. 1992. Dealing with the going concern issue. *The Small Business Controller* (Summer): 51-55.

Koh, H.C. and L.N. Killough. 1990. The use of multiple discriminate analysis in the assessment of the going concern status of an audit client. *Journal of Business Finance and Accounting* (Spring): 179-192.

Kostolansky, John and Gary Porter. 1985. The lender's dilemma: disappearing parent-only statements. *The Journal of Commercial Bank Lending* (June): 22-32.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

LaSalle, Randall E. and Asokan Anandarajan. 1997. Bank loan officers' reactions to audit reports issued to entities with litigation and going concern uncertainties. *Accounting Horizons* (June): 33-40.

_____. 1996. Auditors' views on the type of audit report issued to entities with going concern uncertainties. *Accounting Horizons* (June): 51-72.

LaSalle, Randall E., Asokan Anandarajan, and Allie F. Miller. 1996. Going concern uncertainties: Disclaimer of opinion versus unqualified opinion with modified wording. *Auditing: A Journal of Practice and Theory* (Fall): 29-48.

Libby, Robert. 1979a. Bankers' and auditors' perceptions of the message communicated by the audit report. *Journal of Accounting Research* (Spring): 99-122.

_____. 1979b. The impact of uncertainty reporting on the loan decision. *Journal of Accounting Research* (Supplement): 35-57.

Loudder, Martha L., Inder K. Khurana, Roby B. Sawyers, Cindy Cordery, Carol Johnson, Jordan Lowe, and Robert Wunderle. 1992. The information content of audit qualifications. *Auditing: A Journal of Practice and Theory* (Spring): 69-82.

Louwers, Timothy J., Frank M. Messina, and Michael D. Richard. 1996. The auditor's going concern modification as a self-fulfilling prophecy: a discrete-time survival analysis. Working Paper, University of Houston, Houston, TX.

Menon, Krishnagopal and Kenneth B. Schwartz. 1986. The auditor's report for companies facing bankruptcy. *The Journal of Commercial Bank Lending* (January): 42-52.

Neter, John, William Wasserman, and Michael H. Kurtner. 1990. Applied linear statistical models. Irwin: Homewood, Illinois.

Pany, Kurt and Phillip Reckers. 1987. Within vs. between subjects experimental designs: a study of demand effects. *Auditing: A Journal of Practice and Theory* (Fall): 39-53.

Pany, Kurt and Ralph E. Smith. 1979. What does "subject to" mean in an audit report? *The Journal of Commercial Bank Lending* (November): 31-41.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Pringle, Lynn M., Robert P. Crum, and Robert J. Swetz. 1990. Do SAS No. 59 format changes affect the outcome and the quality of investment decisions? *Accounting Horizons* (September):68-75.

Raghunandan, K. and D.V.Rama. 1995. Audit reports for companies in financial distress: before and after SAS No. 59. *Auditing: A Journal of Practice and Theory* (Spring): 50-63.

Robertson, Jack C. 1988. Analysts' reactions to auditors' message in qualified reports. *Accounting Horizons* (June): 82-89.

Rodgers, Jacci L. 1991. Discussant's comments on:" The wording of audit reports: its impact on the meaning of the message communicated" *Accounting Communication and Monitoring*. 107-114.

Rodgers, Waymond and Thomas J. Housel. 1987. The effects of information and cognitive processes on decision making. *Accounting and Business Research* (Winter): 67-74.

SAS/STAT User's Guide. 1990. SAS Institute Inc. Version 6. Volumes 1 and 2.

Schwartz, Kenneth B. and Krishnagopal Menon. 1985. Auditor switches by failing firms. *The Accounting Review* (April): 248-261.

Seigel, Sidney and N. John Castellan, Jr. 1988. Nonparametric statistics for the behavioral sciences. McGraw-Hill Book Co., New York.

Seipel, Cindy and Larry Tunnell. 1995. An empirical investigation into the relationship between "subject to" going concern opinions and risk shifts. *American Business Review* (June): 1-5.

Shank, John K., Jesse F. Dillard, and Joseph H. Bylinski. 1979. What do "subject to" auditors' opinions mean to investors? *Financial Analysts Journal* (January-February): 41-45.

Shank, John K., Jessee F. Dillard, and Richard J. Murdock. 1978. Lending officers' attitudes toward "subject to" audit opinions. *The Journal of Commercial Bank Lending* (March): 31-45.

Schultz, Joseph J. 1979. Discussion of:" The impact of uncertainty reporting on the loan decision." *Journal of Accounting Research* (Supplement): 64-71.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Srinivasan, V. and Amiya K. Basu. 1989. The metric quality of ordered categorical data. *Marketing Science* (Summer): 205-230.

Stephens, Ray. 1980. Uses of financial information in bank lending decisions. University of Michigan Research Press: Ann Arbor, Michigan.

Strawser, Jerry R. 1991. The role of accountant reports in users' decision-making processes: A review of empirical research. *Journal of Accounting Literature* 10: 181-208.

Wallace, Wanda A. 1991. Accounting research methods. Do the facts speak for themselves? Irwin: Homewood, Illinois.

West, Leonard J. 1977. Design and conduct of educational surveys and experiments. Delta Pi Epsilon. Service Bulletin No. 2.

Whittred, G.P. 1980. Audit qualification and the timeliness of corporate annual reports. *The Accounting Review* (October): 563-577.

Williams, James H. Practitioners' perspectives on going- concern issues. 1984. *The CPA Journal* (December): 13-19.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.