

## CANARIES GONE AWOL (PART 2)

Why Aren't Auditors Helping their Clients by Flagging the Need for Restructurings?



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In Part 1 of this two-part series, published in *IS Chartered Accountant*, April 2015 issue, I explained why auditors are in the best position to identify risk of business failure. Here, I will continue the discussion with new and demonstrably more effective techniques that auditors should employ, and how they can add even more value to an audit.

Auditors are required to regularly assess clients' abilities to continue in existence, regardless of their apparent financial strength, profitability, market dominance or management talent.<sup>1</sup> Depending upon the circumstances, the auditors may need to modify their opinion by adding an emphasis paragraph describing the going-concern uncertainty.<sup>2</sup>

Unfortunately, companies unexpectedly fail within 12 months of their balance sheet dates, and the auditors – the “canaries” expected to warn of forthcoming business failure – may be accused of audit failure. Reducing the frequency of these occurrences is clearly in the profession's better interests. Auditors

<sup>1</sup> ISA 570 *Going Concern* states that sufficient appropriate audit evidence must be obtained and evaluated, including management's process for making its assessment, and the effects of events occurring after the balance sheet date.

<sup>2</sup> In cases where management refuses to discuss a going-concern uncertainty in the notes to the financial statements, the auditors might even have to qualify their opinion or, if the omission makes the statements not true and fair, render an adverse opinion.



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would thus be well served to develop expertise in applying statistical or other methods that would improve the probability of identifying near-term failures. Doing so would lower audit risk and, equally importantly, provide a valuable service for their clients.

### **BANKRUPTCY PREDICTION MODELS MORE SUCCESSFUL THAN AUDITORS**

The procedures employed by auditors in evaluating going concern have been largely subjective and loosely defined, although a variety of techniques have been suggested over the years. Surprisingly, despite their presumed quantitative skills, auditors have not enhanced their capabilities much over the past five decades. Multiple studies reveal that at least half of business failures were not preceded by the early warnings that the inclusion of going-concern language would have provided.

A number of effective formal models have been proposed over the years, three of which – developed by Zmijewski<sup>3</sup>, Ohlson<sup>4</sup>, and Altman<sup>5</sup> – have proven vastly more successful at predicting bankruptcy than have been auditors applying their traditional mix of subjective and analytical tools. The Zmijewski *probit* mathematical model employs a range of financial ratios empirically identified, the Ohlson *logistic regression* model uses defined variables, and the popular Altman *discriminant analysis* model has factors its developer identified. These have been shown successful 82% to 93% of the time in predicting

<sup>3</sup> Zmijewski, Mark E., “Methodological Issues Related to the Estimation of Financial Distress Prediction Models”, *Journal of Accounting Research* 24 (Supplement 1984, pp. 59-82). Also see Clive Lennox, “Identifying Failing Companies: A Re-evaluation of the Logit, Probit, and DA Approaches”, *Journal of Economics and Business* 51 (1999, pp. 347-364).

<sup>4</sup> Ohlson, James A., “Financial Ratios and the Probabilistic Prediction of Bankruptcy”, *Journal of Accounting Research* (Spring 1980, pp. 109-131). Also see [www.stockopedia.com/content/improving-on-the-altman-z-score-part-2-the-ohlson-o-score-70800/](http://www.stockopedia.com/content/improving-on-the-altman-z-score-part-2-the-ohlson-o-score-70800/).

<sup>5</sup> Altman, Edward I., “Financial Ratios, Discriminant Analysis and the Prediction of Corporate Bankruptcy”, *The Journal of Finance* (September 1968, pp. 589-609). A decade later, Prof Altman developed a refined version of the Z-score methodology, referred to as the ZETA Credit Risk Model, which is a proprietary product available only to subscribers.

# TECHNICAL EXCELLENCE

AUDITORS HELPING CLIENTS RESTRUCTURE

businesses' near-term financial failures.<sup>6</sup>

For unexplained reasons, auditors have eschewed these more sophisticated (and often freely available) approaches to prognosticating their audit clients' near-term survivability, thereby constraining the value of audit services. Although no approach can provide absolute assurance of predicting even near-term insolvency, the fact that auditors often fail has been professionally embarrassing and occasionally costly (when clients are lost or litigation ensues). These failures deny clients the opportunity to take timely corrective actions as management itself is often slow to appreciate the extent to which the enterprise is already in jeopardy.

Apart from concern over accountants' liability, it is clear that the auditors' role as a watchdog for the interests of investors, analysts, creditors, and shareholders would be best fulfilled if troubled business situations could be resolved before financial losses are incurred. Management – if forewarned by the auditors who are uniquely positioned to do this – could then, by itself taking steps and possibly by engaging qualified outside service providers, “take arms against a sea of troubles, and by opposing, end them.”<sup>7</sup>

Assuming that auditors can and should serve as the proverbial “canaries in the coal mine”, the value proposition for clients could be significant. This has two implications. First, auditors must learn how to more effectively flag



going-concern difficulties for their clients. And second, they must become comfortable in introducing clients to other professionals they have vetted and found capable of suggesting strategic alternatives that could avert an oncoming debacle.

## BENEFITS OF EARLY INTERVENTION

Even when auditors detect early signals of distress, they may not be equipped to assess and address root causes. Incumbent management, having emotional and/or financial stakes in the existing enterprise and its extant procedures and processes, may also lack the impartial mindset necessary to diagnose the problem(s). Instead, external financial advisors or turnaround professionals, versed in objectively isolating and addressing systemic inefficiencies and breakdowns, might be helpful. Without

active intervention by an auditor, the introduction of such professionals into a situation may occur too late to have the desired impact.

Successful restructurings spring from effective strategies – those crystallising only after a holistic review of available options.<sup>8</sup> Because many managers will not have previously undertaken a restructuring, it might prove critical to include restructuring professionals in the conversation. These may include experts to manage the legal, financial, and operational aspects, and auditors are the best people to identify and include them in the initial conversation. Later, the restructuring professionals so engaged can benefit from the auditors' experience with and knowledge about the company. Serving as providers of information will not threaten the auditors' independence, assuming they do not

<sup>6</sup> This article does not address the implications of the “false positives” that might be indicated by these models, that is, how unwarranted indications of impending failure might result in costly extended auditing procedures and/or might create needless concerns among users of the financials. Neither does this article consider what might be the acceptable trade-offs between the risk of false positives and failures to signal actual going concerns.

<sup>7</sup> William Shakespeare, *Hamlet*, Act III

<sup>8</sup> Available operational and financial restructurings depend upon local laws and customs, but might involve disposing of unprofitable product lines, distribution channels, and vendor or customer relationships, and negotiating with creditors to stretch out payments, reduce interest rates, exchange some or all debt for equity common or preferred positions, or obtaining new financing.





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act as managerial decision-makers.

Some may argue that “restructuring facilitator” does not comport with the auditors’ job description. But although non-traditional, auditors should readily adapt to this role, given their knowledge about clients’ financial and operating practices and circumstances, and their financial analysis, forecasting and budgeting skills. They should want to assist their clients’ continued existence, appreciating that no other professionals are as well-positioned to provide early warning of the need to address deeply-rooted problems threatening their clients’ survival.

### **COLLABORATION AMONG AUDITOR, MANAGEMENT, EXTERNAL ADVISORS**

The need for restructuring becomes obvious when a company encounters

difficulty in making debt payments, but may also be manifested by stagnating growth, narrowing margins, or ill-conceived product or marketing decisions. However, by the time actual consequences are observed, it may be too late. Bankruptcy carries major risks, including the replacement of management, elimination of existing shareholders’ equity, and drastic and permanent reductions in the scope of the company’s operations.

Management should be receptive to observations offered by the auditors, who in turn should be comfortable bringing lurking dangers to management’s attention. Even the most forthright of auditors, however, may lack the skills and experience needed to discuss the range of remedial actions that might be situation-appropriate. Therefore, auditors should acquaint themselves with financial advisors, restructuring attorneys, turnaround managers, and others who might serve as “arrows in their quivers”, to be deployed as needed. Having a database of trusted, available advisors at hand would contribute to above-average client services.

Beyond making introductions, auditors could serve by assisting the restructuring professionals as they gain familiarity and by flagging

issues for their immediate attention. Historically, auditors have been reluctant to do this, but hopefully, after gaining greater familiarity with various restructuring techniques and with those professionals who are qualified to wield them, they will warm to the role of facilitators and information providers, to their and their clients’ mutual benefit.

### **IMPROVING GOING-CONCERN EVALUATIONS**

Auditors have responsibility for assessing their clients’ ability to continue as going concerns for at least one year from the balance sheet date, but have had only modest success at spotting impending insolvencies. Various financial models have been shown to be more perceptive, and auditors should quickly develop the skills to utilise them.

Secondly, auditors should cultivate a coterie of qualified turnaround and restructuring professionals. Having such access will make the auditors significantly more valuable to their clients, whose survival also will benefit the auditors.

Finally, auditors should become comfortable with their expanded role as facilitators and information providers for other professionals. This will not jeopardise the auditors’ independence, and will also provide them with insights that would not be readily obtainable by any other means, which will be useful in subsequent audits of that and other entities. This will also contribute to accountants’ lifelong learning and skills enhancement. Although only a minor fraction of clients will ever need restructuring advisory services, over time, there will be ample opportunity to assist those truly in need. ISCA

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