CANARIES GONE AWOL

Why Aren't Auditors Helping their Clients by Flagging the Need for Restructurings?[1] (Part 1)

BY
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During an out-of-court restructuring or a formal bankruptcy process,[2] official assignees and restructuring professionals not uncommonly will utter the statement (or think to themselves), "Where were the auditors?" or "If only we could have gotten involved sooner." Oftentimes, business managers who ignore signs of impending distress, apply short-term fixes, or delay restructurings only succeed at "digging a deeper hole", destroying value for stakeholders and jeopardising the enterprise.

Inefficiencies and losses only tend to compound over time, "shortening the runway" to achieve a turnaround by draining resources and diminishing credibility of the managers (critical currency in any distress environment). In such an environment, where cash reserves and time horizons (or lack thereof) can dictate success or failure, commencing a restructuring process later, rather than sooner, can greatly diminish the likelihood of rehabilitation. In this regard, the author believes that auditors may be uniquely positioned to serve as sentries who alert managers to issues faced by the company, to facilitate the difficult conversations that may follow, and to perhaps suggest the need to bring in a restructuring attorney or other outside professional advisor.

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AUDITORS IN PRIME POSITION TO IDENTIFY RISK OF BUSINESS FAILURE

The role of an auditor is to express an opinion on whether the reporting entity's financial statements are fairly presented in accordance with Singapore's financial reporting standards (FRS). Fundamental to the expression of this opinion is an assessment of whether the entity is likely, as of the date of the financial statements, to remain a "going concern."[3] This is generally defined to mean that the reporting entity is expected to continue in business for at least a year from the balance sheet date.

There are multiple reasons for this concern. First, of course, users of the financial statements – who are assumed to be economic decision-makers external to the enterprise's management ranks, such as outside investors, lenders, employees, vendors and customers – want to know if the company they have or are

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[1] In the US in the 1800s, coal miners would bring live canaries into mines to serve as warnings of fatal concentrations of carbon monoxide gas, which albeit odourless, is deadly. Canaries, being more sensitive than humans to this gas, would expire first, giving the miners time to escape safely. Likewise, auditors are expected to provide early warnings of impending company failures. Critics have argued that these canaries have long been AWOL, a military term for being absent without official leave.

[2] For example, under Singapore's Bankruptcy Act as revised in 2009; procedures and requirements vary in other jurisdictions.

[3] Singapore FRS 1 *Presentation of Financial Statements*, states that, "[W]hen preparing financial statements, management shall make an assessment of an entity's ability to continue as a going concern. An entity shall prepare financial statements on a going concern basis unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so. When management is aware, in making its assessment, of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, the entity shall disclose those uncertainties. When an entity does not prepare financial statements on a going concern basis, it shall disclose that fact, together with the basis on which it prepared the financial statements and the reason why the entity is not regarded as a going concern.

In assessing whether the going concern assumption is appropriate, management takes into account all available information about the future, which is at least, but is not limited to, 12 months from the end of the reporting period. The degree of consideration depends on the facts in each case. When an entity has a history of profitable operations and ready access to financial resources, the entity may reach a conclusion that the going concern basis of accounting is appropriate without detailed analysis. In other cases, management may need to consider a wide range of factors relating to current and expected profitability, debt repayment schedules and potential sources of replacement financing before it can satisfy itself that the going concern basis is appropriate."

considering investing in, or otherwise engaging with, is going to remain viable for at least the intermediate term. Second, the classification of assets and liabilities in the financial statements, for example, as either current or non-current, would be affected by an expectation of the enterprise not remaining a going concern. For example, long-term debt subject to acceleration clauses would become current liabilities once the enterprise actually fails, and indeed, should often be so classified even before that terminal event. And third, many of the measurements applied in determining amounts to be presented in the financial statements would dramatically vary under alternative assumptions of continuity. Thus, inventories normally reported at historical cost or lower of cost or market would be written down to liquidating value; plant and equipment, carried at amortised historical cost, would be valued at salvage value, and certain other assets, such as goodwill, would probably have zero value under a non-going concern hypothesis.

It may have become a cliché that auditors serve as the "trusted advisors" to their clients, but it is undeniably true that auditors typically have more frequent contact with, and much greater familiarity regarding the financial and operating conditions of, their clients than do other parties external to the organisation, such as bankers and attorneys. It is thus only logical that auditors be alert to the risk of

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[4] The term going concern dates from at least 1620, having been used in an English lawsuit (*Jollife v. Brode*) regarding asset valuation. It was subsequently employed by academic writers on the subject of auditing beginning in the late 1800s, and by those discussing accounting and financial reporting by the early decades of the 20th century. The concept was cited as a formal assumption underlying financial reporting rules set forth in various jurisdictions by the early 1950s.

[5] For example, in the US, the standard-setting body first charged auditors with addressing going concern only when certain indicia of possible failure came to their attention (for example, the auditee's declining revenues or working capital deficit), and only later mandated that a review of survivability be made in all instances, for even the most solidly positioned of their clients, during each audit.

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business failure, not only to fulfil their professional obligations, detailed in the following section, but also – and perhaps even more importantly – to better serve their clients by giving them the precious gift of time to resolve the financial and operating problems that could otherwise adversely seal their fate.

AUDITORS ARE ACTUALLY REQUIRED TO IDENTIFY RISK OF BUSINESS FAILURE

Because the so-called "going concern assumption" has been a basic postulate of financial reporting under FRS (IAS/IFRS) and various national GAAP standards for over 60 years, the legitimacy of financial reporting has always depended, at least implicitly, on the preparers' and auditors' assertions and conclusions that the reporting entity was indeed a going concern.[4] However, it was not until somewhat later that it was explicitly made a responsibility of the auditors to assess the veracity of that assumption, at least in those circumstances in which there were indicia suggesting imminent failure.[5] More recently, consideration of going concern uncertainty has become *de rigueur* in the conduct of every audit.

As the international standards on auditing (ISA 570) note, some financial reporting frameworks (such as Singapore FRS and recently-revised US GAAP) require that management explicitly assess the propriety of reporting under the going concern assumption, while other national standards do not impose that requirement. Regardless of the extent of management's obligation, however, ISA 570 requires that, "The auditor's responsibility is to obtain sufficient appropriate audit evidence about the appropriateness of management's use of the going concern assumption in the preparation of the financial statements and to conclude whether there is a material uncertainty about the entity's ability to continue as a going concern. *This responsibility exists even if the financial reporting framework used in the preparation of the financial statements does not include an explicit requirement for management to make a specific assessment of the entity's ability to continue as a going concern."* (Emphasis added.)

Notwithstanding this requirement however, academic studies have documented that auditors accurately predicted failures (that is, rendering opinions expressing doubts about the reporting entities' ability to continue as a going concern) only about 40% to 54% of the times that companies failed within a year under the weaker, early standard, and that this rate of successful prediction improved only marginally under the strengthened requirements for universal going concern assessments. This record has understandably led to dissatisfaction with auditors' performances and, in jurisdictions where suits against accountants have become commonplace, to efforts by investors to recoup their losses through litigation when the companies in which they have invested later fail, without a warning being registered in the auditor's report.

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WHY ARE AUDITORS UNSUCCESSFUL IN PREDICTING BUSINESS FAILURES?

It has been a too-common misperception that auditors (and, more generally, all accountants) are "numbers people", who can divine their clients' futures by clever analysis of their current financial positions and performances. In truth, accountants are often untrained in, and predisposed to not make use of, the more sophisticated analytical tools that other business observers and advisors (for example, financial analysts, practitioners of operations research) commonly deploy in their work. One glaring example of the validity of this observation has been the almost complete failure of the auditing profession to make use of statistical sampling methodologies in selecting audit evidence, evaluating that evidence, and extrapolating sample findings to the full populations from which they were scientifically drawn. All the major firms attempted to instil the discipline of these techniques beginning in the 1960s, and virtually all have abandoned their use in recent decades. While the decision to revert to non-statistical (judgemental) sampling has several causes, to the author, the most surprising revelation has been the auditors' widespread reluctance to utilise mathematical or statistical procedures.[6]

This same lack of confidence has seemingly also retarded auditors' embrace of more effective tools in assessing their auditees' abilities to survive. In practice, auditors have relied upon subjective assessments, too often coloured excessively by management's optimistic assertions, and the employment of the well-known and useful "Z-score" calculation, to meet their professional obligations. However, as the data confirm, these have been only moderately useful, leaving clients bereft of the early warnings that could salvage the companies and their shareholders' financial interests. ISCA

Part 2 of this article will discuss new and demonstrably more effective techniques that auditors should employ, and their role in bringing additional consulting talents to the table.

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[6] Another likely major reason for abandoning the superior statistical sampling alternatives was related to litigation risk: It is more difficult (presumably) for an opposing expert witness to attack one auditor's use of judgement, for which wide latitude is offered in the professional standards, than it is to cite a failure to follow a statistical methodology's precise requirements. Importantly, even when auditors choose samples consistent with what would have been done had statistical sampling been employed, the results obtained provide less information for the auditors in the absence of using a strict statistical sampling plan, thereby negatively affecting the quality of the audit.

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