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Technical Default, Auditors' Decisions and Future Financial Distress

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SYNOPSIS: The purpose of this paper is to document auditors' responses to first-time debt covenant violations and to determine whether these responses can be used to predict financial distress. The data reveal, consistent with SFAS No. 78, that auditors are more likely to require debt reclassification when the violations are not waived by lenders. In contrast, the waiver decision does not appear to significantly influence the auditor's qualification decision. The empirical tests also show that for firms experiencing technical default, the audit opinion is an important determinant of future financial distress, even after controlling for factors typically associated with bankruptcy.

Data Availability: Data that are used in this study are available from public sources.

INTRODUCTION

Positive accounting theory assumes that debt covenant violation is costly and, as a result, that managers prefer to avoid incidents of technical default (Watts and Zimmerman 1986).[1] Based on this premise, accounting researchers have expended considerable effort determining the types of firms that are most likely to encounter default (Press and Weintrop 1990) and the costs that are associated with default (Beneish and Press 1993). More recently, studies have evaluated how a variety of parties—managers (Defond and Jiambalvo 1994; Sweeney 1994), lenders (Chen and Wei 1993) and investors (Beneish and Press 1995a, 1995b)—respond to incidents of technical default. By documenting the differential reactions that occur across different users, these studies have significantly enhanced our understanding of debt covenant effects.

The present paper complements this line of research by examining auditors' responses to debt covenant violations. The first part of the study investigates the determinants of auditors' debt reclassification and qualification decisions, while the second seeks to determine, conditional on technical default, whether the actions taken by auditors can be used to predict future financial distress. The results indicate that when firms encounter technical default, auditors' actions are influenced in part by the actions of lenders. Specifically, auditors use both financial statement data and waiver decisions in determining the appropriate course of action when their clients experience technical default. Empirical tests also reveal that defaulting firms that receive qualified audit opinions face an increased likelihood of financial distress in subsequent periods. These findings contribute to the literature by documenting how auditors respond to technical

[1] Throughout this paper the terms "covenant violation," "covenant default," and "default" are used synonymously to refer to technical violations of accounting-based or other debt covenants. Technical default differs from debt service default, which involves missed principal or interest payments.

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default and by demonstrating that auditors' decisions can be used to evaluate the situations likely to be faced by violating firms in subsequent periods.

The remainder of the paper is structured as follows. In section two, background information regarding technical default and auditors' decisions is provided. In section three, the data collection procedures are explained and summary data are presented. Section four presents the empirical analysis, and a summary is provided in section five.

BACKGROUND INFORMATION

This section describes the context within which the two types of auditor decisions (qualification and debt reclassification) are made. The general authority regarding debt reclassification comes from SFAS No. 78, *Classification of Obligations that are Callable by the Creditor*. According to SFAS No. 78, the short-term classification is intended to include obligations that are callable either (1) because the act of default triggers the lender's right to accelerate the debt, or (2) because the firm's failure to cure the violation within a specified grace period will make the debt callable. Under either of these conditions, the debt should be classified as current unless a waiver is received or, assuming a grace period exists, if it is likely that the violation will be cured within the grace period (FASB 1983).

Even if waivers are received, however, firms may be required to reclassify the debt as short-term. According to FASB 1986, *Classification of Obligations when a Violation is Waived by the Creditor*, the debt may require current classification if "(a) a covenant violation has occurred at the balance sheet date or would have occurred absent a loan modification and (b) it is probable that the borrower will not be able to cure the default (comply with the covenant) at measurement dates that are within the next 12 months." Therefore, auditors must exercise some judgment regardless of whether lenders have granted waivers at the balance sheet date. Given the provisions of SFAS No. 78, however, firms failing to receive waivers would seem to be more likely candidates for reclassification.

A related issue involves the interaction between the reclassification decision and the audit opinion. Specifically, does the act of reclassification require or suggest that a qualified opinion will be issued? There is little doubt that the two decisions are related; *ceteris paribus*, firms experiencing debt reclassification are more likely to face accelerated repayment and the corresponding liquidity difficulties. As a result, such firms also are more likely to be classified as going concern problems. However, under Statement on Auditing Standards No. 58, reclassification in and of itself does not warrant a change in the auditor's standard unqualified report. In fact, the correlation between reclassification and qualification likely was stronger before AICPA 1988, when qualifications could be granted "subject-to" the effects of a variety of material uncertainties. For example, in this study, which is comprised entirely of pre-SAS No. 58 opinions, 67 percent of the firms having their debt reclassified to short-term received qualified opinions, while only 39 percent were issued going concern qualifications. In essence, although the qualification decision certainly is not independent of the reclassification decision, the existence of one does not necessarily imply the presence of the other.

SAMPLE CHARACTERISTICS

Data Collection

The sample used in this study consists of 159 firms traded on the NYSE/AMEX or NASDAQ, and having initial default dates ranging from 1978 to 1988.[2] To collect data regarding the covenant violations, annual report or Form 10-K filings were examined for each sample firm from year –2 through year +2 relative to the initially identified year of default (i.e., a minimum of five years). This procedure was utilized to determine whether covenants

[2] The sample of firms used in this study comes from three sources: (1) firms used by Chen and Wei (1993); (2) firms used by Beneish and Press (1993); and (3) firms identified using a search of the LEXIS network for the years 1984–1986. Chen and Wei (1993) used Compact Disclosure to identify firms in violation during the years 1985–1988, and Beneish and Press (1993) searched Compact Disclosure, NAARS and the Dow Jones News Service for the years 1983–1987. Many firms were common across two or more of the sample sources and these duplicate firms were included only once.

had been violated prior to the initially-identified event years and whether firms remained in violation after the initially identified event years. If a violation was found in year –2 or –1, financial statements were examined prior to these years until two consecutive years of compliance were discovered. For example, if a firm had been identified as having an initial covenant violation in 1986, but was discovered to have a previous violation in 1984, the initial violation year was redefined as 1984 and years –1 and –2 were redefined as 1983 and 1982. Financial statements in the post-violation period were examined until two consecutive years of compliance were discovered. Therefore, if a firm had an initial violation in 1984 and had additional violations in 1986 and 1987, data were collected from 1982 (year –2) through 1989 (two years of compliance after the final violation in 1987).

Summary Statistics

Summary statistics for the complete sample of firms are presented in table 1. In panel A, median values are summarized as of the end of the fiscal year prior to the initial covenant violation (year –1), the end of the fiscal year of the initial covenant violation (year 0), and the end of the fiscal year subsequent to the initial covenant violation (year +1). Table 1 illustrates that violating firms experienced increasing debt levels and decreasing equity values across the three-year period. Table 1 also shows that covenant violations are associated with decreased liquidity and decreased profitability.[3] Panel B reveals the same trends that are documented by Beneish and Press (1993), namely that firms facing violation have significantly lower equity values, profitability levels and liquidity levels, and significantly higher debt levels than do their industry counterparts. In total, the summary data suggest that incidents of default are likely to be associated with firms that are experiencing deteriorating financial health.

EMPIRICAL RESULTS

Univariate Tests

Auditor Decisions vs. Lender Decisions

This section of the paper presents a series of 2 × 2 contingency tables which examine the association between auditors' and lenders' responses to initial debt covenant violations. In these tables, the response of the auditor is assumed to be the dependent effect. Based on the development in section two, auditors should be more likely to require that the violated debt be reclassified to short-term if waivers are not granted. Similarly, it is expected that firms failing to receive waivers will be more likely to receive qualified audit opinions.

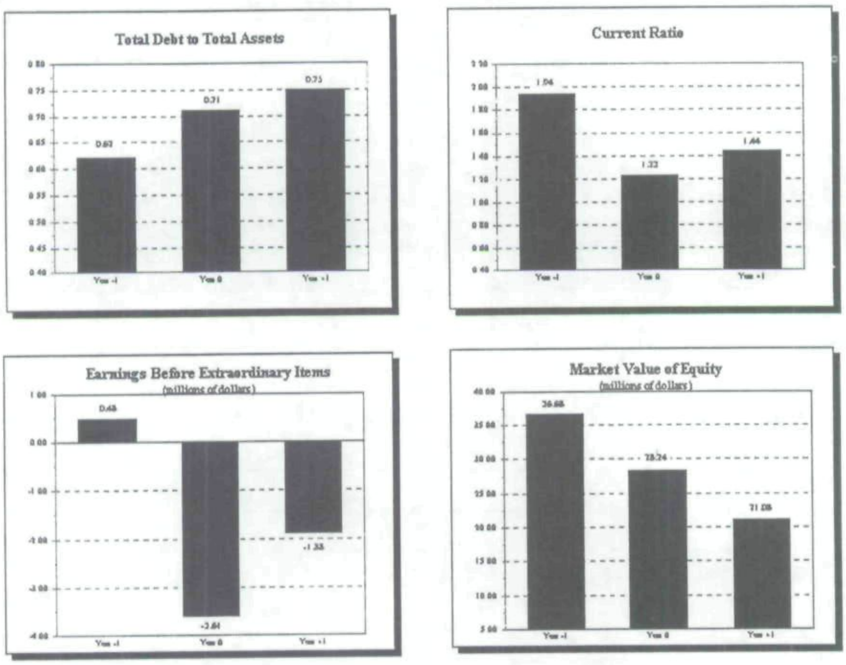
The results of the initial tests are presented in table 2. The data support a significant relation between the waiver partition and the auditor's debt reclassification decision. Only 17 percent (15 of 89) of the firms receiving waivers had their debt reclassified to short-term, while 49 percent (34 of 70) of the firms failing to receive waivers were subject to reclassification. These results are consistent with auditors using lenders' decisions to proxy for the likelihood that debt repayment will be accelerated into the current year. Table 2 also illustrates, however, that auditors exercise a fair amount of judgment when waivers are not granted. Specifically, auditors for over half (36 of 70) of the firms failing to receive default waivers apparently estimated that the violations would be cured within the grace period and, accordingly, retained the debt's long-term classification. This finding counters one of the concerns expressed in comment letters dealing with SFAS No. 78, that the standard "substantially removes any auditor judgment in evaluating how an obligation should be classified when a violation exists." (SFAS No. 78, para. 16)

The results for the auditor's qualification decision are comparable to the findings for the reclassification decision. Of the 70 firms failing to receive waivers, 56 percent were issued qualified opinions. In contrast, only 30 percent of the 89 firms receiving waivers had their audit opinions qualified. Similar associations exist when qualifications are restricted to those citing going concern problems. Roughly two-thirds of the going concern opinions were issued to firms that failed to have their initial violations waived. In total, the data involving

[3] Year-to-year changes in each of the four summary measures are significant at, at least, the ten percent level (two-tailed).

TABLE 1
Median and Mean Values for Selected Financial Measures for the Sample of 159 Firms Experiencing First-Time Debt Covenant Violations

Panel A: Median Values Over Time



Panel B: Comparison to Industry Mean in Year 0

Variable	Firm Mean	Industry Mean	t-Statistic
Debt/Assets	0.73	0.64	4.27**
Current Ratio	1.37	3.07	11.33**
Earnings	−25.65	10.34	4.60**
Equity Value	105.61	306.89	3.96**

** denotes significance at $p \leq = 0.05$.
Data are from the 1995 Compustat tapes.
Debt/Assets = Total Liabilities (Item No. 181)/Total Assets (Item No. 6)
Current Ratio = Current Assets (Item No. 4)/Current Liabilities (Item No. 5)
Earnings = Earnings Before Extraordinary Items (Item No. 18)
Equity Value = Common Shares (Item No. 25) *Common Share Price (Item No. 199)

the waiver partition reveal that auditors incorporate lenders' decisions when they evaluate firms that are in violation of their debt covenants. Because over half of the firms failing to receive waivers were not subject to reclassification, however, auditors do appear to exercise quite a bit of judgment in determining the financial statement presentation of violated debt.

Subsequent Period Problems

The second set of univariate tests, presented in table 3, examines the association between lenders' and auditors' decisions at the date of initial default and financial distress encountered by violating firms in subsequent periods. In this framework, financial distress is defined as either bankruptcy or debt service

TABLE 2
Association Between Auditors' and Lenders' Responses to Initial Debt Covenant Violations

Partition	Debt Not Reclassified	Debt Reclassified
No Waiver	36	34
Waiver	74	15

$\chi^2 = 18.49^{**}$

Partition	Opinion Not Qualified	Opinion Qualified
No Waiver	31	39
Waiver	62	27

$\chi^2 = 10.39^{**}$

Partition	No Going Concern Opinion	Going Concern Opinion
No Waiver	50	20
Waiver	78	11

$\chi^2 = 6.56^{**}$

** denotes significance at $p \leq 0.05$ (two-tailed).

default, which often leads to bankruptcy.[4] The general hypothesis is that firms that fail to receive waivers, that have their debt reclassified to short-term, and that receive qualified opinions will be more likely to face financial distress in future periods.

Table 3 illustrates that lenders' initial waiver decisions are not significant determinants of future distress and that auditors' initial debt reclassification decisions are only marginally significant ($p = 0.08$). Specifically, 39 percent (19 of 49) of the reclassification firms encountered financial distress in subsequent periods, compared to only 25 percent (28 of 110) of firms not experiencing debt reclassification. The qualification decision, however, exhibits a highly significant association with future financial distress. Almost half (31 of 66) of the firms receiving qualified audit opinions eventually experienced debt service default or filed for bankruptcy. In contrast, only 17 percent (16 of 93) of the firms that were issued clean opinions ultimately encountered financial distress. Stated differently, firms receiving qualified opinions account for 66 percent of the incidents of future debt service default or bankruptcy even though they make up a minority of the sample observations. Similar to the previous section, the results are comparable when the qualification partition encompasses only going concern opinions. In sum, the data presented in table 3 suggest that the initial decisions of auditors, particularly decisions involving the audit opinion, can be used to assess the likelihood that firms will encounter future financial difficulties.

MULTIVARIATE TESTS

Table 4 presents three LOGIT models that re-examine the previously discussed associations in a multivariate setting. Given the similar findings for general qualifications and for going concern opinions noted throughout this

[4] The empirical results are qualitatively unchanged under a more restrictive definition which confines financial distress to subsequent bankruptcy filings.

TABLE 3

Relationship Between Auditors' and Lenders' Responses and Future Financial Distress

Partition	**No Future Debt Service Default or Bankruptcy**	**Future Debt Service Default or Bankruptcy**
No Waiver	45	25
Waiver	67	22
	$\chi^2 = 2.28$	

Partition	**No Future Debt Service Default or Bankruptcy**	**Future Debt Service Default or Bankruptcy**
Debt Not Reclassified	82	28
Debt Reclassified	30	19
	$\chi^2 = 2.89$*	

Partition	**No Future Debt Service Default or Bankruptcy**	**Future Debt Service Default or Bankruptcy**
Opinion Not Qualified	77	16
Opinion Qualified	35	31
	$\chi^2 = 16.43$**	

Partition	**No Future Debt Service Default or Bankruptcy**	**Future Debt Service Default or Bankruptcy**
No Going Concern Opinion	96	32
Going Concern Opinion	16	15
	$\chi^2 = 6.56$**	

** and * denote significance at $p \leq 0.05$ and $p \leq 0.10$, respectively (two-tailed).

paper, separate models for firms receiving going concern opinions are not presented.[5] The first two panels of table 4 build from the univariate analysis presented in table 2, and involve the following specifications (expected signs are shown below the variable designations):

$$\text{RECLASS} = \alpha_1 + \gamma_1 \underset{(-)}{\text{WAIVER}} + \gamma_2 \underset{(+)}{\text{QUALIFY}} + \gamma_3 \underset{(+)}{\text{LEVERAGE}} + \gamma_4 \underset{(-)}{\text{ROA}}. \quad (1)$$

$$\text{QUALIFY} = \alpha_1 + \gamma_1 \underset{(-)}{\text{WAIVER}} + \gamma_2 \underset{(+)}{\text{RECLASS}} + \gamma_3 \underset{(+)}{\text{LEVERAGE}} + \gamma_4 \underset{(-)}{\text{ROA}} + \gamma_5 \underset{(-)}{\text{CURRENT}}. \quad (2)$$

[5] As with the univariate tests, models defining "qualification" as "going concern qualification" are very similar to models utilizing a broader definition of "qualification." The similarity is probably attributable to the fact that qualifications issued prior to SAS No. 58 often highlighted material uncertainties such as financing difficulties which were not *initially* significant enough to warrant a going concern opinion. These "subject-to" qualifications, however, may have

(Continued on next page)

Table 4
LOGIT Regressions Involving Initial Auditor Decisions and Future Financial Distress

Panel A: Debt Reclassification Decision

$$\text{RECLASS} = \alpha_1 + \gamma_1\text{WAIVER} + \gamma_2\text{QUALIFY} + \gamma_3\text{LEVERAGE} + \gamma_4\text{ROA}$$

	α_1	γ_1	γ_2	γ_3	γ_4
Coefficient estimate	–2.00	–1.44	1.24	1.88	0.08
t-statistic	–1.90*	–3.06**	2.76**	1.29	0.06

Panel B: Audit Opinion

$$\text{QUALIFY} = \alpha_1 + \gamma_1\text{WAIVER} + \gamma_2\text{RECLASS} + \gamma_3\text{LEVERAGE} + \gamma_4\text{ROA} + \gamma_5\text{CURRENT}$$

	α_1	γ_1	γ_2	γ_3	γ_4	γ_5
Coefficient estimate	–0.82	–0.13	0.92	1.41	–5.05	–1.13
t-statistic	–0.60	–0.27	2.00**	0.94	–3.30**	–2.76**

Panel C: Future Financial Distress

$$\text{DISTRESS} = \alpha_1 + \gamma_1\text{WAIVER} + \gamma_2\text{ RECLASS} + \gamma_3\text{QUALIFY} + \gamma_4\text{LEVERAGE} + \gamma_5\text{ROA} + \gamma_6\text{CURRENT}$$

	α_1	γ_1	γ_2	γ_3	γ_4	γ_5	γ_6
Coefficient estimate	–3.90	–0.34	0.09	1.14	4.04	2.60	–0.04
t-statistic	–2.60**	–0.74	0.19	2.43**	2.45**	1.62	–0.11

** and * denote significance at $p \leq 0.05$ and $p \leq 0.10$, respectively (two-tailed).
DISTRESS = future distress; 0 = none or technical default, 1 = debt service default or bankruptcy,
WAIVER = 1 if initial violations were explicitly waived, 0 otherwise,
RECLASS = 1 if auditors initially reclassified violated debt to short-term, 0 otherwise,
QUALIFY = 1 if initial audit opinion was qualified, 0 otherwise,
LEVERAGE = total liabilities/total assets (Compustat Item No. 181 / Item No. 6),
ROA = earnings before extraordinary items/total assets (Compustat Item No. 18 / Item No. 6),
CURRENT = current assets/current liabilities (Compustat Item No. 4 / Item No. 5).

In models (1) and (2), LEVERAGE is defined as total liabilities divided by total assets, CURRENT is defined as current assets divided by current liabilities, and ROA is defined as earnings before extraordinary items divided by total assets. These three variables—representing financial leverage, liquidity and profitability, respectively—are continuous and are included to control for the basic financial statement effects likely to be incorporated in both the reclassification and qualification decision.[6] All other variables take the value of one when the characteristic is present, and zero when the characteristic is not present. Because the two auditor decisions are not completely dependent, the qualification variable is included in the reclassification model, and vice versa.[7]

Panel A of table 4 presents evidence from the debt reclassification model. The significant negative coefficient for WAIVER reveals that firms receiving waivers are less likely to have

Footnote 5 (Continued)
provided the first indication of potential going concern problems and/or financial distress.

[6] If CURRENT is included in the reclassification regression, the coefficient is significant and of the appropriate sign (negative). However, it is difficult to determine whether reclassification is genuinely more likely when firms are having liquidity problems, or whether the significant negative estimate exists because reclassification mechanically produces lower current ratios. As a result, CURRENT is not included in the formal presentation of model (1).

[7] Although it is likely that the qualification decision is more dependent on the reclassification decision than the reverse, generalizing this relationship is difficult. An additional, and perhaps more likely, possibility is that both decisions are dependent on a subset of the auditor's private information regarding the firm, which is acting as a correlated omitted variable in panels A and B.

their debt reclassified to short-term, a result which is consistent with the development presented in section two. The significant positive estimate for QUALIFY suggests that firms receiving qualified opinions are more likely to have their debt reclassified. This association supports the notion that some interaction exists between the auditor's reclassification decision and the audit opinion. Neither of the control variables is significant at conventional levels. In total, the conclusions that can be drawn from panel A are comparable to those generated by the univariate tests shown in table 2. Specifically, auditors rely, at least to some extent, on lenders' decisions in evaluating whether the debt should be reclassified as current.

In contrast to the findings regarding the debt reclassification decision, panel B of table 4 illustrates that decisions regarding the audit opinion are largely dependent on financial data. The significant negative estimates for both CURRENT and ROA reveal that firms experiencing low liquidity and profitability levels are more likely to receive qualified opinions. The coefficient estimate for RECLASS is significant as well, confirming the positive association between the two auditor decisions that is documented in panel A. After controlling for the reclassification decision and financial statement effects, however, the lender's waiver decision does not contribute significantly to the qualification model.[8] Thus, although a firm's failure to receive default waivers is an important determinant of the balance sheet presentation of the violated debt, measures of financial health appear to be used more consistently in the development of the audit opinion.[9]

Panel C of table 4 presents the final LOGIT specification, which evaluates the importance of auditors' decisions in predicting future financial distress. The specification tested in panel C is as follows:

$$\begin{aligned}\text{DISTRESS} = \alpha_1 &+ \underset{(-)}{\gamma_1\text{WAIVER}} \\ &+ \underset{(+)}{\gamma_2\,\text{RECLASS}} + \underset{(+)}{\gamma_3\text{QUALIFY}} \\ &+ \underset{(+)}{\gamma_4\text{LEVERAGE}} + \underset{(-)}{\gamma_5\text{ROA}} \\ &+ \underset{(-)}{\gamma_6\text{CURRENT}} \qquad (3)\end{aligned}$$

where DISTRESS is equal to 1 if the firm experienced either debt service default or bankruptcy in future periods, and is equal to 0 for all other cases. All other variables are as previously defined.

Panel C of table 4 illustrates that neither the lender's waiver decision nor the auditor's debt reclassification decision is important in predicting future financial distress. Similarly, although liquidity and profitability were found to influence the auditor's qualification decision, neither measure is significantly associated with subsequent distress. The significance of LEVERAGE, however, indicates that firms having high levels of debt at the date of initial default are more likely to encounter bankruptcy in future periods. The auditor's qualification decision is also found to be an important predictor of financial distress. Specifically, the significance of the qualification decision reveals that, given a debt covenant violation, firms receiving qualified opinions have a greater likelihood of experiencing severe financial problems in subsequent periods. Most importantly, this result holds even after controlling for financial statement effects typically associated with an increased probability of bankruptcy.

SUMMARY

The most recent trend in debt covenant research has been to evaluate how different users respond to incidents of technical default. Although studies have examined the responses of managers, investors and creditors, little emphasis has been placed on auditors' reactions to debt covenant violations. The evidence presented in this paper suggests, consistent with SFAS No. 78, that auditors are more likely to require that obligations be reclassified as current when the corresponding violations are not waived. The results also indicate

[8] If RECLASS is omitted from model (2), WAIVER becomes significant. Given the lack of significance in the complete model, however, it is likely that WAIVER simply proxies for RECLASS in the reduced model.

[9] The pairwise correlations between the independent effects in all of the models are relatively high. Collinearity diagnostics, however, do not suggest that the integrity of the models is materially affected.

that, conditional on technical default, the auditor's initial qualification decision is a significant predictor of financial distress, even though such distress may not occur for several years in the future. The latter finding, in particular, offers additional support for Nogler's (1995) defense of the integrity of the audit opinion.

Because the sample used in this study includes pre-SAS No. 58 qualifications, additional research in this area should examine the relation between covenant violations and opinions that are guided by SAS No. 58. Such an analysis would facilitate comparisons between "subject-to" opinions and the explanatory paragraphs that are now used in practice. Researchers may also want to incorporate the opinions of practitioners, gathered via survey or experimental methods, in extending the models presented in this paper.

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