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Summary

In the past years the number of distressed firms filing for reorganization and bankruptcy has significantly increased and auditors are aware of the very difficult worldwide economic crisis. There is a concern about auditors' awareness of matters relevant to the consideration of the use of the going concern assumption in the preparation of financial statements. Firms are faced with the challenge of evaluating the effect of the credit crisis and economic downturn on the entity's ability to continue as a going concern. It is questioned whether these effects on the entity ought to be described, or otherwise reflected, in the financial statements. These are the key messages in the international newsletter "AUDIT Considerations in respect of Going Concern in the Current Economic Environment", issued by The International Auditing and Assurance Standards Board (IAASB) in January 2009. In this context, this study is motivated to contribute to the IAASB newsletter by generating new information to support the challenging nature of the auditor's task to determine whether a company is able to continue as a going concern. Namely, our contribution to the previous literature is to generate information concerning: (1) the behavior and usefulness of single financial ratios in short-term financial distress prediction when the effect of each different financial distress process stage is considered; and (2) the effects of recognition of the financial distress process stage on the financial distress prediction model.

The study findings provide evidence that the financial distress process stage affects the classification ability of single financial ratios and financial distress prediction models in short-term financial distress prediction. That is, the auditor's going concern task could be supported by paying attention to the financial distress process stages. In sum, certain changes in the financial ratios indicate at which stage the firm is. To avoid the increased risk of being held responsible to the stakeholders for the financial consequences of not having issued a GC opinion when needed, or on the other hand having issued one without justification, an auditor should, as part of the decision-making process, examine liquidity ratios when the company is at the final stage. The decision to issue a GC opinion will then be based on the auditor's evaluation and judgment of the adequacy of the company's liquid assets for the next fiscal year.

Our study has implications for general understanding of the behavior of financial ratios during the late stages of a financial distress process. The implications of the current study findings for auditors and every stakeholder of business firms are considered.