Management Going-Concern Disclosures: Impact of Corporate Governance and Auditor Reputation

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ABSTRACT

The UK regulatory requirements relating to going-concern disclosures require directors to report on the going-concern status of their firms. Such directors have incentives not to report fairly in the case of financially distressed firms. Auditors similarly have to report on the going-concern status of their clients via a going-concern modification paragraph in the audit report. They may also have incentives not to act in an independent manner but might be constrained by such issues as the need to maintain their reputational capital and to avoid the risk of litigation. We expect effective corporate governance mechanisms will tend to encourage both directors and auditors to report truthfully.

This paper tests this proposition explicitly using a large sample of U.K. going-concern cases over the period 1994-2000. We find that the auditors' going-concern modification paragraph provides credible information in predicting the subsequent resolutions of going-concern uncertainties. On the contrary, directors' going-concern statements convey arbitrary and unhelpful messages to users. However, robust corporate governance structures and high auditor reputation constrain directors to be more truthful in their going-concern disclosures, thus bringing these more into line with the more credible auditor opinions.

Keywords: Corporate Governance; Auditor behaviour; Going-concern; Financial distress; Cadbury disclosure; Reputational capital

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1. Introduction

The Cadbury Committee on corporate governance's *Going-concern and Financial Reporting – Guidance for Directors* (Cadbury, 1994) mandates directors of listed firms to provide a statement in the annual report on their firm's going-concern status. As the London Stock Exchange (LSE) (now regulated by the Financial Services Authority – FSA) incorporated Cadbury into its listing requirements, disclosures relating to a firm's going-concern status appear in a specific directors' statement as well as the audit report.

We know very little about how management and auditors actually deal with such crucial bad news reporting as the going-concern opinion, which issue should be of major concern to both regulators and the accounting profession. There are several factors that could influence the disclosure behaviour of both directors and auditors towards greater transparency. Auditors may be deterred from opportunistic disclosure behaviour designed to please management by the potential threat to their reputational capital and litigation risk. Conversely, a high level of non-audit fee may encourage them to act less independently. A robust corporate governance system in the audit client firm may again deter directors from disclosure behaviour that serves their own interests rather than those of shareholders. While any restrictions on auditor opportunism should ensure more objective going-concern disclosure decisions, similar constraints on directors are likely to shift their disclosure preferences towards those of auditors, thereby narrowing the gap between them. The audit committee, an important corporate governance device to ensure external audit quality as well as enhanced monitoring of management, may also serve to bridge the divide between management and external auditors.

This paper investigates the impact of *auditor reputation* and corporate governance structure in auditee firms on managements' going-concern disclosure behaviour. In particular, we explore (1) whether such narrative disclosures are *credible* in terms of

their predictive ability, and (2) whether increased monitoring pressure is associated with higher quality going-concern uncertainty disclosures.

Our results demonstrate that the auditors' going-concern modification paragraph provides valuable information in communicating the relative severity of subsequent outcome. Specifically, businesses suffering more severe adverse outcomes have audit reports with a more negative opinion than those experiencing less serious financial distress. On the contrary, the directors' Cadbury going-concern paragraph conveys arbitrary and unhelpful messages to users. Neither its content nor its nature is related in any way to the severity of subsequent outcome. In fact, in almost one half of cases, directors either make no direct statement at all on their firm's going-concern position or make 'optimistic' disclosures which are clearly at odds with the economic realities. This suggests that managers are reluctant to signal their going-concern problems even though these are directly manifest elsewhere in the accounts.

We also find that there exists clear information dissonance between auditors' and directors' disclosures. The audit report going-concern modified (GCM) paragraph conveys messages with a significantly more negative (pessimistic) tone than the directors' disclosure. Since the auditors' opinion is more credible, we conclude that the gap between this and the directors' Cadbury statement mainly derives from inappropriate *management* disclosures. We further find that the magnitude of this discrepancy is inversely associated with degree of monitoring pressure. Importantly, firms subject to closer monitoring have management going-concern disclosures more consistent with the auditors' message. Our results are consistent with effective governance curbing self-serving managerial behaviour.

The remainder of this paper is organised as follows. Section 2 presents the institutional background. Section 3 reviews the prior literature relating to this study. Section 4 describes our hypotheses. Section 5 describes the data and our methodology. Section 6 provides our results. The final section of the paper presents a summary of our results and discusses their implications.

2. Institutional background

The proper signalling of going-concern uncertainties is central to the integrity of the financial reporting statements. As well as the basic duty of the auditor to report on their clients' going-concern status in the audit report (APB, 1993; APB, 1994), the U.K. regulatory framework introduces the major innovation of requiring directors themselves to report on their firm's going-concern status.

The Cadbury Committee's corporate governance regulations *Going-concern and Financial Reporting – Guidance for Directors* (Cadbury, 1994) - for which there is no equivalent in the U.S. - mandates directors of firms listed on the LSE to provide a statement on their company's going-concern status. Cadbury recommends that when directors have weighed up the results of their investigations into the going-concern status of their business, they can reach one of three conclusions.[1] First, if the directors are confident of their business's existence in the foreseeable future, then this is indicated by the basic statement (Cadbury, 1994, para.49): "After making enquiries, the directors have a reasonable expectation that the company has adequate resources to continue in operational existence for the foreseeable future. For this reason, they continue to adopt the going-concern basis in preparing the accounts."

Second, if there are factors that raise uncertainties about the firm's ability to continue to trade in the foreseeable future, but its directors consider it appropriate for the accounts to be drawn up on a going-concern basis, then they should explain the circumstances to identify such factors including any external ones outside their control which may affect the outcome (para.50).[2] The third conclusion envisaged (paragraphs 52-54), where the going-concern basis is not appropriate, is basically a

1 It is worth noting that this directors' disclosure is a recommendation as the regulators appear to believe that stated compliance with a voluntary code will prove more effective than a statutory code. However, they do stress that if companies do not back the recommendations, it is probable that legislation and external regulation would be sought to deal with some of the underlying problems (Cadbury, 1992, para.1.10).

2 The Guidance provides an example in paragraph 51: "The company is in breach of certain loan covenants at its balance sheet date and so the company's bankers could recall their loans at any time. The directors continue to be involved in negotiations with the company's bankers and as yet no demands for repayments have been received. The negotiations are at an early stage and, although the directors are optimistic about the outcome, it is as yet too early to make predictions with any certainty. In the light of the actions described elsewhere in the Operating and Financial Review, the directors consider it appropriate to adopt the going-concern basis in preparing the accounts."

break-up basis. Such a basis is very unusual and our sample does not include any such instance.

The LSE *Listing Rules* 12.43(v) require such directors' statements dealing with the company's adoption of the going-concern basis to be 'reviewed' by the auditors before publication.[3] To meet the review requirements, the auditors are required to assess the consistency of the directors' going-concern statement with the knowledge obtained in the course of the audit of the financial statements and whether the statement meets the Cadbury requirements.

3. Prior research

Investors, regulators and the accounting profession are all concerned with the quality of corporate disclosures by the management of distressed companies and its monitoring by audit firms. Prior research has addressed both of these areas of interest.

3.1 Management disclosure behaviour and corporate governance

Consistent with agency theory arguments, studies document that managers have incentives to window-dress their accounting numbers (e.g., Watts and Zimmerman, 1978). Other studies provide evidence on managerial bias in corporate disclosure reporting (news management), (e.g., see the survey of Healy and Palepu, 2001). Amongst studies focusing specifically on financial distress, Mutchler, et al. (1997) suggest that issuing bad news, especially in the case of serious financial distress, might bring about firm failure, and Frost (1997) concludes there are severe incentive problems with voluntary disclosures by stressed firm managements.

These studies imply that, when the company is financially distressed, disclosure decisions are more likely to be influenced by managers' wealth or welfare considerations, leading to more serious agency problems. Thus managerial stock ownership in the distressed firm may induce managers to be less pessimistic about going concern uncertainties. This may not however be in the interests of the larger body of shareholders, although in the agency model of the firm such ownership is

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[3] The APB (1998) strongly distinguishes the responsibility of 'review' from that of 'audit.'

intended to promote managerial and shareholder alignment. However, many of these problems, in theory at least, should be mitigated by robust corporate governance mechanisms. The following sub-sections review these issues.

3.1.1 Impact of board structure on managerial behaviour

Closer monitoring of managers may reduce agency problems and lead to increased disclosure quality. Such monitoring is a function of the corporate governance (CG) structure in the client firm. CG structure includes the relative power of the chief executive officer (CEO) and the board of directors, the degree of independence of the board from executive management, the presence of an explicit monitoring device, e.g., the audit committee operated by the board, the size of the board, and whether the posts of CEO and chairman of board (COB) can be held by one person (termed duality here).

Non-duality is argued to ensure independence and superior monitoring capability of the board (Baliga et al., 1996; Brickley et al., 1997). In fact, one of the major recommendations of the Cadbury Report in the U.K. was for boards to institute non-duality. However, empirical evidence on the impact of non-duality on performance is inconclusive (e.g., Dahya et al., 2002; Lai and Sudarsanam, 1997). Another indicator of the power of the CEO is his or her tenure with long tenure indicating a more entrenched top management and therefore greater power to influence the external auditor as well as dilute the monitoring effectiveness of the board (Beasley, 1996).

While small board size is believed to improve monitoring and corporate performance (Jensen, 1993; Yermack, 1996), a larger board may have a greater range of expertise to monitor management as well as oversee the external audit effectively (Beasley, 1996; Cohen et al., 2002). The degree of board independence, i.e. the proportion of independent directors on the board, is also argued to improve monitoring. Several studies have examined the impact of the proportion of independent or non-executive directors on corporate performance (e.g., Dahya et al. 2002; Dahya and McConnell, 2003; Lai and Sudarsanam, 1997).

3.1.2 Impact of audit committee on managerial behaviour and external audit

An important recommendation of the Cadbury Report is to create an audit committee

of the board made up substantially of independent or non-executive directors, inter alia to monitor the external audit process and to insulate the external audit from executive management inducements, thereby ensuring a more objective audit. The external auditor, on this basis, should therefore be able to report more independently on any going-concern uncertainties. Evidence on the effectiveness of audit committees, however, is conflicting (e.g., Klein, 2002; Cohen et al., 2002). Ours is the first study to examine the impact of audit committees on the nature of management's going concern uncertainty disclosures.

3.1.3 Influence of institutional shareholders

The Cadbury Report (Cadbury, 1992) stresses the role of shareholders in enhancing corporate governance (paras.6.10 and 6.11). However, whether such shareholders actually exert power to influence managers' decisions is a controversial issue. Some studies find that institutional investors do exercise a significant degree of control over management (e.g., Brickley, et al., 1988; Pound, 1988; McConnell and Servaes, 1990). Others do not support this notion (e.g., Brancato, 1996; Gaved, 1997; Pomeranz, 1998). In this paper we explicitly test for the impact of institutional shareholder monitoring on the quality of firm going-concern disclosures.

3.1.4 Lender monitoring of management

Jensen (1989) argues that lenders, as one of the principals of the firm, have both the incentive and a cost-effective opportunity to monitor borrower management. This monitoring role is particularly critical in financially distressed firms. Ofek (1993) and Lai and Sudarsanam (1997) provide empirical evidence that lenders are able to monitor and influence the restructuring strategies of financially distressed firms. It may, therefore, be expected that strong lender monitoring will force managers to be more truthful in their disclosure of going-concern uncertainties.

3.1.5 Overview of corporate governance impact

Based on the above arguments we thus identify the following aspects of a firm's corporate governance structure as potentially able to influence both the quality and consistency of management's and the external auditors' going-concern disclosures:

- CEO-COB duality or non-duality i.e. separation of the two roles

- CEO tenure
- Board size
- Proportion of non-executive or outside directors on the board
- Presence of an audit committee
- Level of institutional shareholdings, and
- Level of debt and other liabilities

In theory, non-duality, high proportion of non-executive directors, audit committee, high institutional shareholdings and large debt should increase disclosure quality and reduce the gap between auditors' and directors' disclosures because they enhance monitoring effectiveness. On the other hand, CEO tenure, reflecting entrenched top management, should reduce quality and widen the gap. There are no prior expectations associated with board size *per se*.

3.1.6 Political and social monitoring

The political cost argument is that larger firms are more politically visible and thus subject to higher levels of public, governmental and capital market scrutiny than smaller businesses. Empirical research lends support to this argument by providing evidence that disclosure quality is positively associated with firm size (e.g., Chow and Wong-Boren, 1987; Meek et al., 1995; Brown and Deegan, 1998). Similarly, larger firms generally are more heavily followed by analysts (e.g., Bhushan, 1989; Shores, 1990). Managers of larger firms are arguably at higher risk of being the target of securities litigation or activist shareholders or social responsibility activists if they do not act properly.

3.2 Auditors' incentives and disincentives for biasing going-concern opinions

Prior research into auditor going-concern reporting focuses on whether or not they made such disclosures in an appropriate manner. Audit firms are subject to conflicting incentives in making going-concern disclosures. Among incentives towards bias and management-friendly going-concern reporting are fear of not being retained for audit work in the future and forfeiture of lucrative non-audit fee income from the audit client. Among the disincentives to such opportunism are the potential erosion of reputational capital and the related litigation risk (Balachandran and Nagarajan, 1987; DeJong, 1985; Melumad and Thoman, 1990; Narayanan, 1994;

Nelson et al., 1988). Erosion of reputational capital may lead to the opportunity cost of lost audit work in future. But litigation risk that also encompasses regulatory risk of punitive sanctions imposed by regulators has more direct and often catastrophic financial consequences such as the collapse of Andersen in the aftermath of the Enron scandal in 2002. Auditor behaviour is therefore likely to be determined by these opposite incentives, jeopardising reputation and increasing litigation risk. In fact, Kornish and Levine (2004) argue that an auditor may be economically motivated to attest wrongly to the financial statements of a financially troubled client.

Audit firms' reputational capital and litigation risk, as well as their capacity to earn non-audit fees, vary. In general, large firms are able to offer a wider range of non-audit services than small firms. Large audit firms are also more vulnerable to assault on their reputational capital and to litigation and regulatory risk because of their high profile and their 'deep pockets' that can compensate victims of their negligent or fraudulent behaviour. Moreover, newly appointed auditors may face these pressures to a greater extent than long-tenured auditors. Management may also use auditor change to signal its displeasure with the independent posture of the previous incumbent putting the new auditor on notice not to adopt a similar posture. We also examine whether these factors bring management's going-concern disclosures more into line with those of auditors.

We identify the following aspects of auditor characteristics as potential determinants of audit quality as revealed in their GCM disclosures:

- Reputational capital
- Litigation risk[4]
- Proportion of non-audit fee in total fee income
- Recent auditor change

In theory, while the first three should enhance audit report quality and narrow the gap between auditors and managers, change in auditor may lead to reduced quality and widen the gap.

[4] We explore the potential impact of litigation risk in section 6.4.2 Robustness Tests below.

4. Hypotheses

As described above, the U.K. audit and corporate governance regimes require firm management as well as its auditors to report appropriately on going-concern uncertainties. However, previous research points to concerns regarding both managerial agency problems and auditor independence in the case of stressed firms. In this study we explore whether managers and auditors abide by the relevant regulatory requirements. In particular, we test whether the U.K. innovation in going-concern reporting, the Cadbury disclosure requirement, has been successful in enforcing effective communication by management of the firm's going-concern status.

Since firms receiving a GCM audit report will experience varied subsequent outcomes,[5] we expect that if going-concern disclosures are to be useful for economic decisions they should provide an accurate signal of the relative severity of subsequent outcomes. We designate the relative severity of the signal contained in the text of the going-concern disclosures as its 'tone'. As such, null hypothesis H_1 is set up as follows:

H_1: *There is no difference in the tone of going-concern disclosures between companies subsequently suffering serious outcomes and those only experiencing moderate financial distress*

Information consistency is a vital quality characteristic of financial reporting. Conflicting information signals may not only be unhelpful but also positively damage the usefulness of the underlying message (Smith and Taffler, 1995; Freedman and Stagliano, 1995). As the U.K. going-concern regulatory regime requires both management and auditors to report on the firm's going-concern status, any dissonance between their contemporaneous disclosures will be of key concern to users of financial statements. We thus set up null hypothesis H_2:

H_2: *There is no information dissonance in signalling the extent of going-concern problems between the auditor's and management's disclosures*

[5] Some may end up with bankruptcy filing or liquidation, while others may experience only moderate financial distress and recover in the subsequent year.

In theory, efficient corporate governance can mitigate managers' opportunistic behaviour. As such, we expect that firms subject to higher degrees of monitoring through efficient corporate governance structures will exhibit better disclosure quality in this crucial bad news reporting area. Auditor characteristics and incentives are also likely to have a similar impact. We thus test the following two null hypotheses, H_3 and H_4:

H_3: *Efficient corporate governance structure leads to no improvement in consistency of going-concern disclosures between auditors and managers*

H_4: *Auditor reputation leads to no improvement in consistency of going-concern disclosures between auditors and managers*

5. Data and methodology

5.1 Data

This study focuses on all non-financial companies receiving an audit going-concern modification (GCM) with shares fully listed on the London Stock Market or trading on the Unlisted Securities Market (USM).[6] GCMs are identified by word search of the *KR On Disc UK Company Factfinder* monthly CD-ROM supplied by Dialog. The specific joint phrase searches used are 'going-concern' and 'our opinion … not qualified.'[7]

One hundred and seventy nine cases, composed of 162 firms trading on the main market and 17 on the USM, represent all the GCMs with financial year-ends between June 30, 1994 [8] and January 3, 2000 with information published on or before the August 2000 CD-ROM. Full-text going-concern disclosure content is taken from the Dialog database, subsequent outcomes from the SEQUENCER database and the

[6] The Cadbury corporate governance requirements (1994) apply to all listed companies registered in the U.K. including companies registered on the Unlisted Securities Market until its demise at the end of 1996.

[7] This wording is required by the relevant auditing standard (APB, 1993, para.54) which, in dealing with fundamental uncertainty modifications, states that: "when adding an explanatory paragraph, auditors should use words which clearly indicate that their opinion on the financial statements is not qualified in respect of its contents."

[8] This is the first financial year-end for which the Cadbury Guidance is effective.

Hemscott Company Guide, financial data from *DATASTREAM* and stockholding data from annual reports. Data about board structure are taken from the PwC Corporate Register and the annual reports of our firm population.

Auditor firm audit and non-audit fees are drawn from the league tables published by *Accountancy*, the journal of the Institute of Chartered Accountants in England and Wales (ICAEW). The league tables were only available for the years 1992-95 although our sample period covers 1994-2000. Because of the lack of full contemporaneous data we use these as proxies for auditors' various revenue sources during the sample period.

5.2 Narrative disclosure measures

We measure going-concern disclosure tone in two ways. First, content analysis methodology is used to develop a scoring schema to quantify the information content of the relevant management and auditor disclosures (TONE1).[9] An alternative measure for the directors' statements alone (TONE2) is based on their choice of the relevant Cadbury explanatory paragraph.

TONE1 is derived using a word-based content analysis approach which is fully described in Appendix 1. Variables A and D relate to the degree of risk signalled by the audit opinion and the directors' Cadbury statement respectively. These measures are calculated in terms of difference in proportions of positive words to negative words in the respective going-concern narrative. Thus, each variable is derived as $(k_p – k_n) / k_t$ where k denotes number of words, p = positive, n = negative and t = total and, by definition, lies in the range – 1 to + 1.

As described in section 2 above, Cadbury (1994) requires directors to report on their firms' going-concern status in one of two ways, depending on whether they believe going-concern uncertainties exist (paras. 50-51) or not (para. 49). This measure of tone, TONE2, is represented by a binary variable depending on which Cadbury

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[9] Content analysis methodology has been widely used to deal with financial statement narratives (e.g., Kelly-Newton, 1980; Ingram and Frazier, 1980; Tennyson, et al., 1990; Abrahamson and Amir, 1996; Bryan, 1997).

Guidance option is exercised by the directors and is categorised as ‘pessimistic’ or ‘optimistic’.

5.3 Research design

To test whether auditor and management going-concern narratives signal the severity of subsequent outcomes appropriately (hypothesis H_1), we first classify firms as ‘severely stressed’ or ‘less stressed’ depending on the nature of the resolution of the going-concern uncertainties. If their disclosures are credible, we expect that the tone measures for severely stressed firms will be more negative than those for less stressed firms. We also examine whether the contemporaneous sources of going-concern disclosures (i.e., A and D) are consistent with each other (H_2).

To test whether corporate governance structure and auditor characteristics mitigate information dissonance between auditor and management disclosures (H_3 and H_4), three alternative regression models are formulated:

Model			
1	GAP_i =	(auditor characteristics, control variables)	(1)
2	GAP_i =	(corporate governance structure, control variables)	(2)
3	GAP_i =	(auditor characteristics, corporate governance structure, control variables)	(3)

The dependent variable GAP_i is the TONE1 score difference between the two disclosures (D-A) associated with firm i.

5.4 Explanatory and control variables

Following section 3.2 above, auditor characteristics and incentives are proxied by the following explanatory variables:

AUDSIZE = 1 if Big5/Big6 accounting firm; 0 otherwise

AFEEREV = % of total audit fee income to total revenue for incumbent auditor (auditor level variable)

CLIENTIMP = ratio of total fee paid by client to auditor’s total fee income (importance of client’s fee to auditor)

NONAUDFEE = ratio of non-audit fee to total fee paid by client firm, and

AUDCH = 1 if auditor has changed from the previous year; 0 otherwise.

Following section 3.1 above, we proxy the various corporate governance mechanisms with the following explanatory variables:
NDUAL (non-duality) = 1 if CEO is a different person from COB; 0 otherwise
BOARD = board size, i.e. number of directors, both executive and non-executive
IDIRBD = % of non-executive (independent) directors on board at balance sheet date
AUDCOM = 1 if there is an audit committee; 0 otherwise
DIROWN = % of equity held by directors at balance sheet date
INSOWN = % of equity held by institutional shareholders at balance sheet date
TENURE = CEO tenure in years at balance sheet date, and
LEV = lender monitoring proxy i.e., total debt to total assets at balance sheet date.

Political and social monitoring is represented by:
FIRMSIZE = firm size as measured by its market capitalisation in £m at balance sheet date.

Control variables consist of:
CURRENT = current ratio, i.e. current assets to current liabilities at balance sheet date
DIV = dividend payment dummy = 1 if dividend paid; 0 if nominal/omission
EPS = earnings per share dummy = 1 if positive; 0 if negative
ROA = return on assets
Z-SCORE = risk of company failure (Taffler, 1984), if z-score < 0, the firm is at risk of failure
QO = any other concurrent audit modification = 1 if present; 0 otherwise, and
TIMING = GCM timing dummy = 1 if a continuing GCM; 0 if a first-time GCM.

6. Results

6.1 Sample characteristics

Table 1 classifies the subsequent events befalling the 179 firm cases in our sample for which complete outcome data for the year subsequent to receiving a GCM were available. Panel A shows 10% of firms subsequently fail, i.e., enter into formal

insolvency proceedings,[10] and a further 14% are acquired or otherwise lose their listing. Forty six percent survive a further year but receive another GCM. Only 30% of the firms continue trading and have a clean audit report in the following set of accounts.

Panel B shows that, of the 179 firms, 25 cases have a rights issue of more than 1:1[11] (defined as a rescue rights) or issue new shares raising more than their market capitalisation (defined as rescue shares) as at the last balance sheet date. Eighteen cases experience financial reconstruction. Four cases issue new debt raising more than 30% of market capitalisation at their last balance sheet date.

In 23 cases, companies dispose of assets for a consideration of more than 30% of the carrying amount of their total assets at the last balance date. Of the 132 continuing firms,[12] 103 (78%) have a negative z-score in the following year and 29 (22%) have a positive z-score. Seventy five (57%) have an improving z-score while 57 (43%) a deteriorating one.

[Table 1 here]

Table 2 provides descriptive statistics on the auditor characteristics and corporate governance variables. Seventy one percent of the firm cases are audited by Big 5/6 audit firms. Audit fee is on average 40% of total fees earned by auditors. In 11% of cases the auditor has changed from that in the previous year.

Eighty percent of firm cases have non-dual i.e., separate CEO and COB positions and 83% have audit committees. Mean board size is 7.65 directors and 30% of directors are non-executive. On average, directors own 9.5% of their firms' equity and institutional ownership is 32%. Mean firm size is £17.38 (median = £5.53m), and average CEO tenure is 3.2 years.

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[10] Represented by administrative receivership or creditors' voluntary liquidation.

[11] Seasoned equity offerings where existing shareholders subscribe for at least as many new shares as they already hold.

[12] Of the 179 cases, 43 were no longer trading as independent entities in the following year and z-scores could not be derived for a further 4 cases because of the absence of a turnover figure.

Among the control variables, mean z-score is –7.0, indicative of a high degree of financial distress. This is also reflected in a mean return on assets figure of –0.44. Only four of the firm cases receive other audit modifications, while 40% have repeated GCMs.

[Table 2 here]

6.2 The predictive ability of going-concern disclosures

6.2.1 Disclosure content and subsequent outcomes

Table 3 provides test results for the credibility of the auditors' going-concern opinion and the directors' Cadbury going-concern statement in terms of predictive ability of subsequent outcomes.

We classify subsequent outcome as being either "severely" or "less" stressed (see panel A of table 1). Firms continuing in existence and receiving a subsequent clean audit report are grouped into the less stressed category (n = 54). We use three benchmarks to classify those firms experiencing a variety of more negative outcomes as severely stressed: (1) receivership etc. (n = 18), (2) non-continuing outcomes (including receivership cases) (n = 43) and (3) non-continuing and GCM cases (n = 125). We expect that if going-concern disclosures have predictive ability, firms suffering severely stressed outcomes will have more pessimistic content, as measured by our variable TONE1.

[Table 3 here]

Table 3, panel A demonstrates that the auditors' going-concern modification paragraph provides valuable information in discriminating the severity of subsequent outcome across all three benchmarks. Specifically, companies with more severe adverse outcomes have audit reports with a more negative tone than those experiencing less serious financial distress, the difference being significant at conventional levels for all benchmarks using both parametric t and non-parametric Wilcoxon rank-sum tests. For example, non-continuing firms (e.g., those entering receivership or being acquired, etc.) had audit going-concern modified reports with mean TONE1 content score of -0.063, compared with those successfully resolving going-concern difficulties with mean content score of -.038, a difference significant at $p < 0.01$. On this basis, we have evidence to reject null hypothesis H_1 with respect to

auditors' disclosures. The auditor's going-concern opinion is credible in signposting the severity of subsequent financial stress outcomes.

In contrast, the directors' statement, as shown in panel B, conveys arbitrary and unhelpful messages to users. The tone of disclosure content is not significantly associated in any way with the severity of subsequent outcome at any conventional levels. We are thus unable to reject null hypothesis H_1 as far as the directors' own going-concern statement is concerned.

6.2.2 Disclosure style and subsequent outcomes

To gain further insight into the relevance of the directors' disclosure, or otherwise, we also test whether the Cadbury directors' disclosure style variable TONE2 (as defined in section 5.2 above) does convey useful information in distinguishing between subsequent outcomes.

Table 4 summarises the manner in which directors report on their going-concern status. The results indicate that, to a considerable extent, directors are not in compliance with the Cadbury requirements. There are no fewer than 87 (49%) out of the 179 cases in which directors fail to provide an appropriate pessimistic disclosure setting out their firm's going-concern uncertainties in accordance with paragraphs 50 and 51 of the Cadbury Guidelines (1994). In 56 cases (31% of the total) they provide the standard paragraph 49 disclosure indicating lack of going-concern problems, and in the remaining 31 cases (18% of the total), in essence, they provide no opinion on their company's going-concern status despite being required to do this by the Cadbury Guidelines (Cadbury, 1994, para.47). Appendix II provides examples of each of these types of director disclosure.

[Table 4 here]

We expect that if such disclosures are to provide valuable information to accounts users, then firms with severely stressed subsequent outcomes are more likely to have a pessimistic directors' statement than are less stressed companies. Using the same outcome categories as in Table 3, however, there is no evidence for this. Thus, for the most severe subsequent outcome category (1) where the comparison is between receivership (severely stressed) (n = 18) or continuing with a subsequent clean audit

report (less stressed) (n = 54), the directors' Cadbury statement results in only a 51% correct classification rate (p-value, 2-tailed = 0.91).[13] Similarly, for outcome category (2) when firms are non-continuing (severely stressed) (n = 43) and compared with those continuing with a clean audit report (less stressed) (n = 54), the rate of correct classifications is only 48% (p-value, 2-tailed = 0.84). For subsequent outcome (3), the 179 cases where the comparison is between non-continuation or subsequent GCM (severely stressed) (n = 125) versus continuing with a clean audit report (less stressed) (n = 54) the rate of correct classifications is 45% (p-value, 2-tailed = 0.23). Thus, again, in all cases, we have no evidence to reject null hypothesis H_1 as far as directors' disclosures are concerned.

6.3 Consistency of contemporaneous going-concern disclosures

Table 5 demonstrates a significant discrepancy in the signalling of severity between the two contemporaneous disclosures. The audit GCM paragraph conveys a message with a significantly more negative (pessimistic) tone (mean TONE1 score = -0.048) than the directors' Cadbury statement (mean TONE1 score = 0.039). This difference is significant at $\alpha = 0.01$ ($t = 18.2$). Median differences tell a similar story. As such, we are forced to reject null hypothesis H_2 suggesting that there is a high level of information dissonance between auditors and management in signalling the extent of going-concern problems.

[Table 5 here]

The following example illustrates typical information dissonance between the directors' and auditors' messages. The auditors of the African Lakes Corporation PLC (1996) drew the attention of financial statement users to their client's uncertain going-concern status via the following explanatory paragraph:

> "In forming our opinion, we have considered the adequacy of the disclosures made in the financial statements concerning the ability of the Group to meet a commitment to one of its bankers of £1,800,000 which was due on 31 March 1997. The financial statements have been prepared on a going-concern basis, the validity of which depends upon the

[13] Optimistic disclosures and disclosures providing no opinion at all are grouped together as 'non-pessimistic' in this test.

> ability of the directors to secure the additional finance required to meet this liability. The financial statements do not include any adjustments that would result from the required finance not being available. Details of the circumstances relating to this fundamental uncertainty are included later in note 22. Our opinion is not qualified in this respect."

However, the directors did not make any reference at all in their going-concern statement about the problems affecting their firm adopting the standard Cadbury para. 49 formulation:

> "After making appropriate enquiries, the directors have a reasonable expectation that the company can obtain adequate resources to continue in operational existence for the foreseeable future. For this reason they continue to adopt the going-concern basis in preparing the group's financial statements."

Since auditors' opinions have a high level of credibility (as shown in panel A of table 3), we conclude that the gap between the auditors' opinion and the director's Cadbury statement is largely the result of inappropriate *management* disclosures.

6.4 Impact of auditor and corporate governance characteristics on information consistency

Table 6 reports three multiple regression models regressing our information consistency variable GAP against auditor reputation and governance measures of interest. Together with control variables, model 1 focuses on auditor characteristics, model 2 on corporate governance variables and model 3 includes both sets of independent variables. On the basis of this analysis we reject our null hypotheses, H_3 and H_4.

[Table 6 here]

6.4.1 Auditor and corporate governance characteristics

We find that auditor reputation, measured by audit firm size, and their incentives to ensure high quality disclosure as proxied by the ratio of audit fees to non-audit fees significantly reduce dissonance between auditors' and directors' going-concern disclosures. The remaining three auditor reputation variables, recent auditor change, level of non-audit fees, and importance of the individual client to the incumbent auditor have no impact on dissonance.

Of the corporate governance structure variables, we have clear evidence (at $p<.01$) that institutional equity ownership is associated with increased convergence between auditors' and directors' going-concern narratives. However, there is also some weaker evidence that percentage of non-executive directors on the board in specification 2 ($p=0.09$) and board size in specification 3 ($p=0.08$) have a similar association with reduced dissonance.

On the other hand, we find no evidence that excessive concentration of power as proxied by dual CEO-cum-COB, entrenchment of top management as measured by CEO tenure or higher levels of directors' stock ownership reduce the quality of management reporting of going-concern uncertainties. Similarly, presence of an audit committee is no guarantee that the disclosure gap between auditor and management is reduced.

Contrary to expectations, lender monitoring, as proxied by leverage, yields counter-intuitive results with the relationship apparently highly significant but with the wrong sign. On this basis, it appears creditor monitoring is inadequate to deter directors from reporting overoptimistically about their distressed firm's going-concern prospects.

Nevertheless, with regard to political and social monitoring pressures, as proxied by firm size, the evidence suggests that larger firms resort to less going-concern narrative manipulation consistent with expectations that higher external profile will impose constraints on managerial self-serving behaviour.

Among the control variables, higher current ratio, return on assets and z-score, and presence of a dividend payment are all significant in the full model (specification 3) and increase dissonance. Perhaps, not surprisingly, less financially distressed firms' directors deviate more from the auditors' GCM than those of more severely distressed firms possibly because they can find a less adverse story to disclose, despite the presence of underlying threats to their firms' continued existence. The explanatory power of the full model is about 22% and all three model specifications are significant at the 1% level.

In summary, our evidence suggests that the incentives of external stakeholders like high reputation auditors and institutional equity holders play a more effective monitoring role that constrains managerial biases in going-concern reporting than purely internal corporate governance mechanisms. In addition, political and social monitoring does appear to promote greater congruence of perceptions between auditors and directors and deter directors in larger firms from putting an unduly favourable spin on their going-concern disclosures. The significant impact of certain auditor characteristics and some corporate governance characteristics thus lead us to reject our null hypotheses H_3 and H_4.

6.4.2 Robustness checks

To ensure our results are robust to alternative definitions of auditor reputation and their reliance on audit fee income, we rerun our regressions with two alternative definitions of AFEEREV.[14] We also substitute, for AUDSIZE, litigation risk to auditors (LITG, a dummy variable that assumes a value of 1 when there is actual or potential litigation-related news for the incumbent auditor in the 2 years prior to the balance sheet date of the sample firm and 0 otherwise)[15]. Finally, we replace bank debt[16] for LEV since bankers may be more effective monitors than creditors in general. This substitution reduces the sample size significantly because of lack of data on bank debt (between 162 cases for specification 1 to 132 for specification 3).

In the re-run regressions,[17] the alternative formulations of AFEEREV have the same significant and negative impact as the original variable in table 6. Litigation risk has a significant and negative impact on our dissonance measure similar to AUDSIZE. However, bank debt has a weaker influence than LEV but nevertheless still has a positive counter-intuitive sign.

[14] Specifically, we use the average percentage of audit fee income in the total revenue of incumbent auditors during 1992 to 1994 and 1993 to 1995.

[15] Audit firm litigation risk is proxied by involvement in actual or potential litigation as evidenced by media reports in Lexis-Nexis in the two years prior to the GCM year.

[16] The variable is defined as total bank debt/total assets.

[17] The full regressions for all robustness checks are not presented here.

7. Discussion and conclusions

The Cadbury corporate governance régime in the U.K. requires company directors to report explicitly on their firm's going-concern status. This enables us to examine the credibility of distressed firm management disclosures in a unique context and also compare these with the credibility of the auditors' going-concern uncertainty disclosures. We identify the incentives and scope to be transparent and forthright for the auditors in their GCM audit report and for directors in their Cadbury going-concern statement. Then, we test whether corporate governance mechanisms and auditor reputation are effective in bringing directors' going-concern disclosures into line with those in the auditors' going-concern audit report. We also investigate the effect of political and social monitoring on directors' disclosure behaviour.

Using content analysis methodology and a sample of 179 financially distressed firms all of which have auditors' going-concern modifications (GCMs) during 1994 to 2000, our results demonstrate that the text of the auditors' GCM paragraph provides valuable information in distinguishing among subsequent outcomes. Specifically, companies subsequently experiencing more adverse outcomes have audit reports with a more negative tone than those experiencing less serious financial distress. This finding suggests that, although a prime source of the public's dissatisfaction with the audit profession is that companies fail without prior warning in their audit report, once audit GCM reports are issued, their content conveys credible information to accounts statement users. Such evidence may contribute to the debate about the purpose and usefulness of the audit going-concern report.

On the contrary, directors' Cadbury going-concern statements largely convey arbitrary and unhelpful messages to users. This suggests that managers are reluctant to signal their going-concern problems when their firm is in such a financially stressed situation, even though there are no apparent costs in so doing given the presence of the auditors' going-concern opinion in the same annual report document.

Given the above results, we conclude that there exist serious agency problems in managers' reporting of bad news, justifying concerns about the disclosure quality of the going-concern messages provided by stressed company management. However,

we have no evidence to support concerns about auditors' disclosures within these GCM cases, conditional on such opinions being expressed in the first place.

However, these serious agency problems can be mitigated by effective monitoring, as evidenced by less information dissonance between managers' and auditors' going-concern disclosures when indicators of closer monitoring are present. Regarding auditor characteristics we find that auditor reputation, risk of litigation and importance of audit fees in the overall revenue mix of auditors are factors that bring directors' disclosures more into line with those of the auditors.

In addition, we have some evidence consistent with certain corporate governance monitoring mechanisms mitigating directors' bias in their formal going-concern disclosures. However, not all of the traditional corporate governance devices are effective in doing so. We find that higher institutional stock ownership provides more effective monitoring than other devices in this context, although board size and a high proportion of non-executive directors have some weaker impact. Furthermore, high levels of political and social monitoring, as proxied by firm size, appear to reduce directors' opportunistic going-concern disclosure activity.

Table 1

Subsequent Outcomes after Receiving an Audit Report Modified for Going-concern Uncertainty Consideration

Panel A: Subsequent outcomes	No.	Percent	No.	Percent
Receivership, etc. [a]			18	10 %
Merged	2	1 %		
Acquired	14	8 %		
Listing cancelled	9	5 %		
Other non-continuing outcomes			25	14 %
Continuing but subsequent GCM			82	46%
Continuing and subsequent clean audit report			54	30 %
Total cases			179	100 %

Panel B: Additional subsequent outcomes	No.
Major financial difficulties [b]	
Issuing rescue rights or shares [c]	25
Financial reconstruction [d]	20
Issuing major debt [e]	4
Major disposal [f]	23
Financial distress measures [g]	
Sign of z-score [h]	
Negative	103
Positive	29
Changes in z-score	
Improving	75
Deteriorating	57

[a] Firms subsequently entering administrative receivership or creditors' voluntary liquidation.
[b] Some firms experienced more than one situation.
[c] Rescue rights are defined as a rights issue more than 1:1 and rescue shares as fund raising more than market capitalisation.
[d] Includes 5 companies experiencing 'debt-equity' swap, 1 debt write-down and 12 capital reduction.
[e] Defined as fund raising more than 30 percent of market capitalisation.
[f] Defined as consideration for disposal of more than 30 percent of the carrying amount of total assets.
[g] Excludes 4 cases without z-score due to no turnover and 43 entering into receivership or other non-continuing outcomes.
[h] The Taffler (1984) z-score approach predicts financially stressed firms with scores less than zero.

Table 2

Descriptive Statistics for Explanatory Variables

Variable[a]	Mean	Median	Number of cases
Panel A: Auditor characteristics variables			
AUDSIZE	0.71	1.00	179
AFEEREV	0.42	0.42	177
CLIENTIMP	0.98	0.29	166
NONAUDFEE	0.19	0.19	177
AUDCH	0.11	0.00	179
Panel B: Corporate governance and monitoring variables			
NDUAL	0.80	1.00	179
BOARD	7.65	7.00	179
IDIRBD	0.30	0.30	179
AUDCOM	0.83	1.00	179
DIROWN	9.53	3.00	179
INSOWN	31.95	34.00	179
TENURE	3.21	2.58	175
LEV	0.54	0.35	179
FIRMSIZE (£m)	17.38	5.53	179
Panel C: Control variables			
CURRENT	0.92	0.82	179
DIV	0.08	0.00	179
EPS	0.16	0.00	179
ROA	-0.44	-0.20	179
ZSCORE	-7.03	-6.96	175
QO	0.04	0.00	179
TIMING	0.40	0.00	179

[a]*Key*
AUDSIZE = 1 if Big5/Big6; 0 otherwise
AFEEREV = % of total audit fee income over total revenue for incumbent auditor (auditor level variable)
CLIENTIMP = ratio of total fee paid by client to auditor's total fee income (importance of client's fee to auditor)
NONAUDFEE = non-audit fee to total fee paid by client firm
AUDCH = 1 if incumbent auditor is different from that in previous year; 0 otherwise.
NDUAL (non-duality) = 1 if CEO and COB are different persons; 0 otherwise
BOARD = board size, i.e. number of directors, both executive and non-executive
IDIRBD = % of non-executive directors on board at balance sheet date
AUDCOM = 1 if there is an audit committee; 0 otherwise
DIROWN = % of equity held by directors at balance sheet date
INSOWN = % of equity held by institutional shareholders at balance sheet date
TENURE = CEO tenure in years at balance sheet date
LEV = lender monitoring proxy i.e., total debt to total assets at balance sheet date
FIRMSIZE = market capitalisation of firm at balance sheet date in £m
CURRENT = current ratio, i.e., current assets to current liabilities at balance sheet date
DIV = dividend payment dummy = 1 if dividend paid; 0 if nominal/omission
EPS = earnings per share dummy = 1 if positive; 0 if negative
ROA = return on assets
ZSCORE = risk of company failure (Taffler, 1984), if z-score <0, the firm is at risk of failure
QO = any other concurrent audit modification = 1 if present; 0 otherwise, and
TIMING = GCM timing dummy = 1 if a continuing GCM; 0 if a first-time GCM.

Table 3
The Credibility of Going-concern Disclosures in Terms of Subsequent Outcomes

This table provides test results for the assessment of credibility of prospective going-concern disclosures derived from content analysis scores (TONE1) and based on subsequent actual outcome benchmarks. Companies are grouped as severely stressed or less stressed depending on different subsequent outcome benchmarks. Both parametric t-tests and non-parametric Wilcoxon rank-sum tests are used to examine the TONE1 difference in means and (unreported) medians between the two groups. *, **, *** indicate significant at the 0.1, 0.05 and 0.01 levels (one-tailed test), respectively.

		TONE1 score of severely stressed firms		TONE1 score of less stressed firms			Wilcoxon
	Subsequent outcome severity	No.	Mean	No.	Mean	t-value	z-value
	Panel A: Auditors' opinion						
(1)	Receivership vs clean cases	18	-.071	54	-.038	-3.57 ***	-3.69 ***
(2)	Non-continuing vs clean cases	43	-.063	54	-.038	-3.37 ***	-3.34 ***
(3)	Non-continuing or GCM vs clean cases	125	-.053	54	-.038	-2.52 **	-2.40 **
	Panel B: Directors' statement						
(1)	Receivership vs clean cases	18	.030	54	.044	-.87	-.68
(2)	Non-continuing vs clean cases	43	.041	54	.044	-.22	-.03
(3)	Non-continuing or GCM vs clean cases	125	.038	54	.044	-.69	-.62

Table 4

The Assessment of the Credibility of Directors' Choice of Cadbury Disclosure (TONE2) in Terms of Subsequent Outcome

	Number of cases		% of cases	
Pessimistic disclosures[a]		92		51
Optimistic disclosures[b]	56		31	
Neutral disclosures[c]	31		18	
Total "non-pessimistic" disclosures		87		49
		179		100

Key:

[a] Pessimistic disclosures are defined as cases where directors report in accordance with paragraphs 50 and 51 of the Cadbury Guidelines (1994) detailing the nature of their firm's going-concern uncertainties.

[b] Optimistic disclosures are defined as cases where directors report in line with the usual paragraph 49 of the Cadbury Guidelines (1994) indicating confidence in their firm's continuing existence in the foreseeable future.

[c] Neutral disclosures are those which merely refer the reader to the notes to the accounts, with or without a statement as to whether the directors consider the going concern basis appropriate.

Table 5
The Consistency of Going-Concern Disclosures

Variables A and D are the disclosure scores (variable TONE1) derived from the auditors' going-concern opinion and the directors' Cadbury statement respectively. The score is measured by the difference between proportions of positive words and negative words in the relevant disclosure.

Variable	No.	Mean	Median	S.D.	Min.	Max.
A	179	-.0482	-.0484	.037	-.111	.055
D	179	.0396	.0390	.054	-.100	.175

The paired t-test for the difference between mean disclosure scores is significant at the 0.01 level (t = 18.2).

Table 6

Regression of Disclosure Dissonance between Directors' and Auditors' GCM on Auditor and Corporate Governance Characteristics

Dependent variable is GAP_i, the TONE1 score difference for firm i between the directors' going-concern disclosure content analysis score and that for the audit opinion (D-A). Explanatory variables represent auditor characteristics, corporate governance characteristics and control variables.

		Dependent Variable (GAP)								
		Specification 1 (n=162)			Specification 2 (n=171)			Specification 3 (n=158)		
Variable Expected Sign	Expected Sign	Estimate	t-value	p-value	Estimate	t-value	p-value	Estimate	t-value	p-value
Intercept		0.22	6.32	**0.00**	0.14	4.70	**0.00**	0.26	6.19	**0.00**
AUDSIZE	−	-0.06	-3.54	**0.00**				-0.04	-2.28	**0.01**
AFEEREV	−	-0.22	-3.55	**0.00**				-0.22	-3.50	**0.00**
CLIENTIMP	+	0.00	0.54	0.29				0.00	0.67	0.25
NONAUDFEE	+	0.07	1.10	0.14				0.02	0.37	0.36
AUDCH	+	-0.02	-0.98	0.16				-0.01	-0.43	0.33
NDUAL	−				0.01	0.68	0.25	0.01	0.47	0.32
BOARD	−				0.00	-0.89	0.19	0.00	-1.42	**0.08**
IDIRBD	−				-0.06	-1.33	**0.09**	-0.05	-1.06	0.15
AUDCOM	−				0.01	0.85	0.20	0.02	1.16	0.12
D IROWN	+				0.00	-0.08	0.47	0.00	-0.12	0.45
INSOWN	−				0.00	-4.37	**0.00**	0.00	-4.34	**0.00**
TENURE	+				0.00	-0.06	0.48	0.00	-0.77	0.22
LEV[b]	−				0.01	1.78	0.04	0.02	2.51	0.01
1n (FIRMSIZE)	−				-0.01	-2.29	**0.01**	-0.01	-2.16	**0.02**
CURRENT	?	0.00	0.21	0.83	0.03	3.02	**0.00**	0.02	2.00	**0.05**
DIV	?	0.03	1.42	0.16	0.02	0.97	0.33	0.04	2.09	**0.04**
EPS	?	0.00	-0.22	0.83	0.02	1.08	0.28	0.02	1.11	0.27
ROA	?	0.00	0.65	0.51	0.01	1.14	0.26	0.01	1.97	**0.05**
ZSCORE	?	0.00	1.56	0.12	0.00	1.07	0.28	0.00	1.85	**0.07**
QO	?	0.00	-0.04	0.97	0.00	-0.13	0.90	0.00	0.10	0.92
TIMING	?	-0.01	-0.94	0.35	-0.01	-0.78	0.44	-0.01	-1.19	0.24
Adj. R^2			0.10			0.12			0.22	
F			2.42[a]			2.46[a]			3.13[a]	

Note: For all auditor characteristics, corporate governance, and political monitoring variables, one tailed tests apply; for control variables, two tailed tests apply.

[a]F statistics all significant at 1% or better

[b]Although LEV has t-statistics apparently significant in specifications 2 and 3, its sign is wrong so it is not significant on a one-tailed test basis.

[c] *Key*
AUDSIZE = 1 if Big5/Big6; 0 otherwise
AFEEREV = % of total audit fee income over total revenue for incumbent auditor (auditor level variable)
CLIENTIMP = ratio of total fee paid by client to auditor's total fee income (importance of client's fee to auditor)
NONAUDFEE = non-audit fee to total fee paid by client firm
AUDCH = 1 if incumbent auditor is different from that in previous year; 0 otherwise.
NDUAL (non-duality) = 1 if CEO and COB are different persons; 0 otherwise
BOARD = board size, i.e. number of directors, both executive and non-executive
IDIRBD = % of non-executive directors on board at balance sheet date
AUDCOM = 1 if there is an audit committee; 0 otherwise
DIROWN = % of equity held by directors at balance sheet date
INSOWN = % of equity held by institutional shareholders at balance sheet date
TENURE = CEO tenure in years at balance sheet date
LEV = lender monitoring proxy i.e., total debt to total assets at balance sheet date
FIRMSIZE = market capitalisation of firm at balance sheet date in £m
CURRENT = current ratio, i.e., current assets to current liabilities at balance sheet date
DIV = dividend payment dummy = 1 if dividend paid; 0 if nominal/omission
EPS = earnings per share dummy = 1 if positive; 0 if negative
ROA = return on assets
ZSCORE = risk of company failure (Taffler, 1984), if z-score <0, the firm is at risk of failure
QO = any other concurrent audit modification = 1 if present; 0 otherwise, and
TIMING = GCM timing dummy = 1 if a continuing GCM; 0 if a first-time GCM.

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APPENDIX I CONTENT ANALYSIS PROCEDURE

Form-orientated analysis and meaning-orientated (thematic) analysis are two alternative generic approaches to content analysis (Krippendorff, 1980; Weber, 1990). Form-orientated analysis involves routine counting of points, words, sentences, lines, concrete references or paragraphs while thematic analysis focuses on analysis of the underlying themes in the texts under investigation. The thematic approach requires researcher judgment in the determination of the hidden messages conveyed in the narratives and thus has difficulties in application. The form- orientated approach is a direct measure and more reliable in terms of coding process. According to Jones and Shoemaker's (1994) review of content analysis studies in accounting words is the most common recording unit in form-orientated analysis. However, it should be noted that word-based content analysis is subject to the assumption that frequency of word occurrence directly reflects the degree of emphasis.

Our content analysis was conducted in four stages. First, content words were differentiated from non-content ones. Content words represent the central theme of the narrative while non-content words, which have little to do with thematic content, are redundant for spoken or written language purposes (Frazier, et al., 1984). Frazier, et al. (p.319) suggests that non-content words are usually 'articles', 'prepositions' or 'conjunctions'. In this first stage, the Oxford Concordance Program (OCP) (Hockey, 1994) was used to list every word in the relevant sets of going-concern narratives together with its frequency and then to generate an alphabetic sort and concordance for each of the words occurring.

Next, employing the OCP KWIC (keyword-in-context) facility, three of the researchers separately identified lists of potential content words, i.e., those that could possibly connote positive or negative meaning.

Third, the resulting content-word roots from the derived pooled list were then independently classified as 'positives,' 'negatives' or 'neutrals' (others) by the coders. To reduce the subjectivity of sign judgment, Haried's (1972) semantic evaluation structure, which is designed for the accounting context, was used as a theoretical

framework. Words connoting ‘good / beneficial / safe’ are defined as positive and words connoting ‘bad / adverse / risk’ as negative. The three coders then met to compare their lists and to resolve disagreements.

Finally, before resolving disputes among the coders, inter-coder reliability was tested using Krippendorff’s agreement coefficient (α) as the measure of reliability (see Krippendorff, 1980, p.138). The agreement coefficient is formulated as follows: $\alpha = 1 - (D_o / D_c)$, where D_o = observed disagreement, D_c = expected disagreement by chance.

112 signed-word-roots were finally identified, 34 connoting a positive tone, 51 a negative tone and the remaining 27 word-roots being classified as neutral as neutral tone or other. The inter-coder reliability index was 0.84 before resolving disputes among the coders. Anything above a value of around 0.70 is generally viewed as indicating an acceptable level of inter-rater agreement (Krippendorff, 1980, p.147).

The two going-concern narratives for each firm were then separately analysed to arrive at the associated variable values on the basis of the different proportions of positive words to negative as proportions of total words in the text.

APPENDIX II EXAMPLES OF DIRECTORS' CADBURY (TONE2) DISCLOSURES FOR GCM COMPANIES

EXAMPLE 1 OPTIMISTIC DISCLOSURE (PARAGRAPH 49)

Company: BEVERLEY GROUP PLC – 1997

After making enquiries and as described in note 1 to the accounts, the directors have a reasonable expectation that the Group has adequate resources to continue in operational existence for the foreseeable future. For this reason, they continue to adopt the going-concern basis in preparing the accounts.

EXAMPLE 2 PESSIMISTIC DISCLOSURE

Company: FERRUM HOLDINGS PLC – 1994

The Company meets its day to day working capital requirements through overdraft facilities which are repayable on demand. The nature of the Group's business is such that there can be considerable unpredictable variation in the timing of cash inflows. The directors have prepared projected cash flow information for the period ending 12 months from the date of their approval of these accounts. On the basis of this cash flow information and discussions with the Company's bankers, the directors consider that the Group will continue to operate within the facilities currently agreed and those which they expect to be agreed on renewal.

The current facilities fall due for renewal between July and September 1995. However, the margin of facilities over requirements is not large and, inherently, there can be no certainty in relation to these matters. On this basis, the directors consider it appropriate to prepare the accounts on the going-concern basis. The accounts do not include any adjustments that would result from a withdrawal of the overdraft facilities by the Group's bankers.

EXAMPLE 3 PESSIMISTIC DISCLOSURE

Company: PRIME PEOPLE PLC – 1994

The financial statements have been prepared on a going-concern basis, the validity of which depends upon shareholder approval for the proposed acquisition and a partly underwritten rights issue, details of which are contained in note 23.

The group's projections confirm that external funding is now required to meet known liabilities as they fall due. If shareholders or warrant holders vote against the proposals set out in note 23 the future of the group would be uncertain and as a consequence the going-concern basis of accounting may be inappropriate. In these circumstances adjustments may be required to the assets and liabilities included in the financial statements.

EXAMPLE 4	NEUTRAL DISCLOSURE
	Company: GEI INTERNATIONAL PLC – 1999
	The financial statements have been prepared on a going-concern basis; see note 1 to the financial statements.