

An Examination of the Association Between S&L Financial Distress and Independent Auditors' Opinions

Zabihollah Rezaee*¹ and Saeed J. Roohani²

¹University of Memphis, Memphis, TN USA

²Bryant College, Smithfield, RI USA

Public accounting firms, especially the Big 5, have incurred (and continue to incur in some cases) significant litigation costs for cases related to alleged audit failures stemming from the S&L crisis of the 1980s. There have been several theories of causes of such audit failures. This study investigates the existence of an association between publicly traded S&Ls' financial condition during the period 1985-89 and the type of audit opinion rendered by their independent auditors. This question is addressed in a three-step process. First, distress is predicted using a logistic regression model containing three explanatory variables (profitability, GAAP capital solvency, and asset quality), representing different causes of S&L distress. The result is that the model is significant in predicting distressed firms over the five-year study period, and the model's classification accuracies are reasonably high in all years. Second, the study examines the frequency of going-concern qualified opinions rendered over the last three years of the study period and finds that only in the last two years of the study did auditors begin to qualify their opinions with any degree of frequency across the sample firms. Third, the financial condition of the firms is compared over time. This is accomplished by comparing the probabilities of correct classification in one year with those of the next year to determine if there was significant deterioration in the financial condition of the firms during the one-year period of comparison. The only year in which a statistically significant deterioration in the S&Ls' financial condition occurred and a higher frequency of going concern opinions was observed is the 1988-89 period. The results indicate that the three distress measures are significantly related to the distress classification, but that the qualified reports are not associated with the financial condition of the firms during the study period (1985-1989). Based on these results, the study concludes that (1) auditors were influenced by factors other than those of financial statements in rendering their audit opinions, and (2) the financial condition of the distressed firms in the study were equally undesirable in the previous years and did not unexpectedly deteriorate to warrant qualified audit reports. Results suggest that auditors either became aware of S&Ls' weak financial condition late in the crisis or were only willing to issue going-concern opinions with any degree of frequency after deterioration became so pervasive that they were forced to issue qualified opinions. Results also suggest that the use of more professional skepticism and "forensic-type" fieldwork by auditors could have provided early signals of S&L financial distress.
