

THE GOING CONCERN OPINION: A TIME FOR A REFERENDUM?

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I. Abstract:

This paper addresses the large and growing problem of identifying business enterprises for which a 'Going Concern Opinion' (GCO) might be appropriate, and the means by which such decision are reached. Changes in corporate financial health, as they relate to the management and auditor assessment regarding the requirement for issuing a GCO, are fraught with challenges. However, by defining and applying 'Bright Line' methodology, material changes in corporate financial health may be made on a prospective basis. This determination should assist the auditor in making a GCO decision.

II. Introduction: History and Importance

Business bankruptcies in the U.S. have cycled up and down over the recent past rising to new levels in terms of asset dollars and number of occurrences involved in 2008 and 2009.

¹ For purposes of this paper, an Inflection Point is defined as a material change in corporate financial health – positive or negative. A Bright Line is a threshold value which requires a different accounting treatment if exceeded.
² "US bankruptcy surge puts 1 trillion dollars in courts," Jan. 13, 2009, www.acs.gov.cn/cms/sites/www/images/2009/1/20/13.doc and <http://www.BankruptcyData.com>

Table 1: U.S. Business and Non-business Bankruptcy Filings
 (Years Ended December 31, 2002-2008 & September 30, 2009)

Year	Total	Non-Business	Business
2009	1,402,816	1,344,095	58,721
2008	1,117,771	1,074,225	43,546
2007	850,912	822,950	28,322
2006	617,660	597,965	19,695
2005	2,078,415	2,039,214	39,201
2004	1,597,462	1,563,145	34,317
2003	1,660,245	1,625,208	35,037
2002	1,577,651	1,539,111	38,540

Source: Administrative Office of the U.S. Courts: http://www.uscourts.gov/Press_Releases/

It has been reported that in 2008, the value of assets of U.S. publicly traded entities in bankruptcy exceeded \$1.16 trillion dollars setting a new high.² Moreover, for the annual period ending September 30, 2009, the number of business bankruptcy filings grew from just over 28 thousand in 2007 to almost 58 thousand in 2009 – another record. This represents an increase from 2007 to 2009 in the number of filings of over 100%.

Bankruptcy filings result in major economic dislocations for the U.S. economy resulting in many lost jobs, asset obliteration, and significant losses for equity and debt holders, creditors and suppliers. Such

bankruptcies and attendant losses have ripple effects throughout the economy thereby exponentially increasing such economic dislocations. Bankruptcies certainly played a part in the record \$7.3 trillion of stock market value lost in 2008 in the U.S.³

Often, in the period before a business bankruptcy filing, a Going Concern Opinion (GCO) should be issued by the entity's auditors. This is most recently seen as being remiss in the case of Lehman Brothers (the largest bankruptcy on record with some \$691 billion in assets involved), and General Motors (with approximately \$91 billion in assets), where a GCO was only issued in the period of the bankruptcy filing.

Because of these colossal bankruptcy failures and the attendant auditors only citing a GCO in the year of bankruptcy filing, auditors need better tools in making GCO determinations so as to better make the investing public and creditors aware of potential financial meltdowns.

III. Auditor Requirements and Responsibility:

Historically, management is responsible for reporting the entity's financial position and results of operations while maintaining adequate and

³ Douglas, M. 27 Feb. 2009, "United States: The Year in Bankruptcy: 2008," Jones Day. Article may be found at <http://www.Mondaq.com/unitedstates/article.asp?articleid=75256>

functioning internal controls. The auditor is responsible for attesting to the material correctness and a fair presentation of the financial statements. That is, the auditor not only tests for material accuracy and fair presentation of financial information, but also attests to management's assertions regarding the financial statements. However, the marketplace also believes the auditor is assessing the entity's viability in future periods beyond the next annual cycle. That is, the market is buying the future, not the past. So auditors are charged with making a GCO during the audit of a client if warranted. Such a determination involves making an assessment as to whether the client has the financial wherewithal to continue to operate beyond the upcoming accounting cycle (usually the next twelve months). Auditors are guided by SAS 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*.⁴ Basically this pronouncement requires the auditor to consider the following items:

- 1) Can the entity meet its obligations as they become due without having to liquidate assets, restructure debt, be forced by outside entities to change operations, etc.,
- 2) Negative trends – consider recurring operating losses, working capital deficiencies, negative cash flows from operating activities, material negative changes in key financial ratios,
- 3) Indicators - Determine if there were defalcations on loans or other agreements, whether technical loans covenants were not

⁴ American Institute of Certified Public Accountants (AICPA) Statement on Auditing Standards (SAS) 59, http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Authoritative+Standards/auditing_standards.htm . The International Financial Reporting Standards (IFRS) do not permit reporting under IFRS if there is a GCO. In fact International Accounting Standard 1, *Presentation of Financial Statements*, requires that an entity consider "all available information about the future, which is at least, but not limited to, twelve months from the end of the reporting period," in making an assessment regarding a Going Concern Opinion.

- maintained, dividend payments not met, denial of customary credit terms, non-compliance with statutory capital or other requirements, requires new sources of capital or is required to dispose of assets not in the normal course of business,
- 4) Internal Factors – work stoppages, substantial dependence on a single or limited set of projects, uneconomic long-term obligations, need to materially revise operations,
 - 5) External factors – material legal proceedings, regulatory legislation or other environmental changes that might place the entity in jeopardy, technology elasticity issues, loss of a key franchise, employees, licenses, patents, material customer or supplier, or uninsured or underinsured assets or operations.⁵

In 2008, the Financial and Accounting Standards Board (FASB) issued an exposure draft that requires management to now make a going concern assessment and disclosure effective in 2009. This exposure draft would create a longer time horizon for management than is presently stipulated for auditors.⁶

IV. Discussion of the Facts:

It has been shown that auditors often fail to indicate, or only indicate a GCO in the audit report in the entity's last financial statement preceding or

⁵ Putra, L.D. 2009. "Concerning Auditor's Going Concern Qualification." For a good review of the Going Concern Requirement, please see: <http://accounting-financial-tax.com/2009/10/concerning-auditors-going-concern-qualification>

⁶ Putra, L.D. 2009. "Concerning Going Concern Opinion." *Accounting, Financial and Tax*, October 23, 2009. <http://accounting-financial-tax.com/2009/10/concerning-auditors-going-concern-qualification/>

including the period of bankruptcy since SAS 59 became effective.⁷ In the study just referenced, Venuti shows that 202 of the 257 publicly traded bankrupt companies that filed for bankruptcy in 2001, only 48% of these companies contained a GCO. That is, 52% did not contain such an opinion.

Table 2: Selected Public Company Bankruptcy Filings 1980 – Present

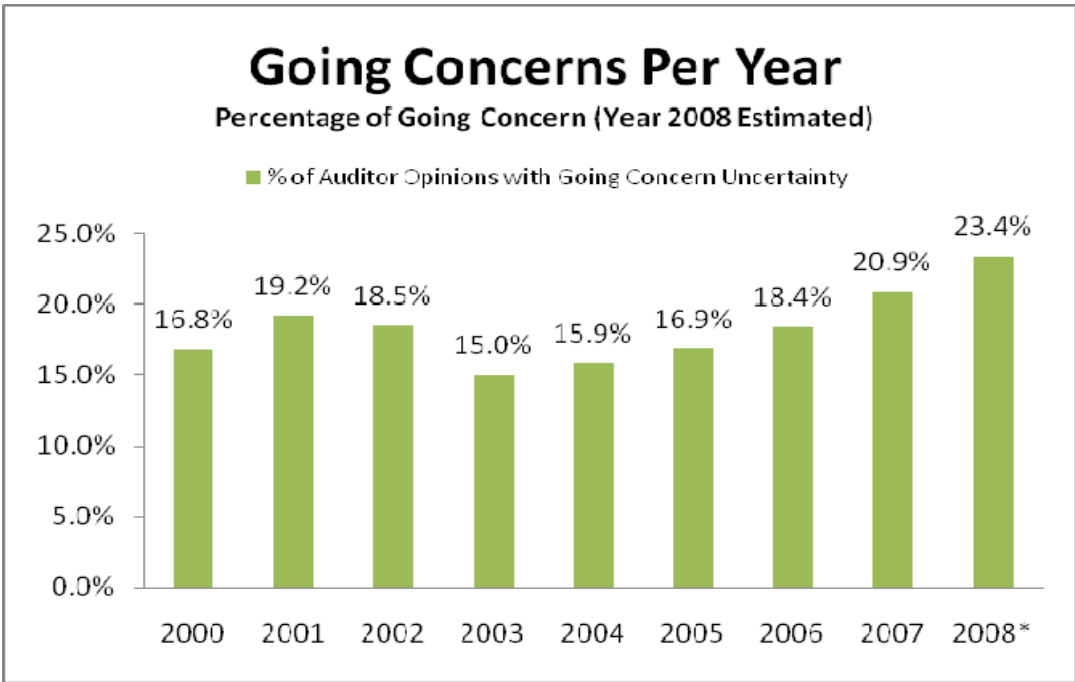
Company	Bankruptcy Date	Description	Assets In \$s 000,000s Omitted
Lehman Brothers Holdings Inc.	09/15/08	Investment Bank	691,063
Washington Mutual, Inc.	09/26/08	Savings & Loan Holding Co.	327,913
WorldCom, Inc.	07/21/02	Telecommunications	103,914
General Motors Corporation	06/01/09	Manufactures & Sells Cars	91,047
CIT Group Inc.	11/01/09	Banking Holding Company	80,448
Enron Corp.	12/02/01	Energy Trading, Natural Gas	65,503
Conseco, Inc.	12/17/02	Financial Services Holding Co.	61,392
Chrysler LLC	04/30/09	Manufactures & Sells Cars	39,300
Thornburg Mortgage, Inc.	05/01/09	Residential Mortgage Lending Company	36,521
Pacific Gas and Electric Company	04/06/01	Electricity & Natural Gas	36,152
Texaco, Inc.	04/12/87	Petroleum & Petrochemicals	34,940
Financial Corp. of America	09/09/88	Financial Services & Savings and Loans	33,864
Refco Inc.	10/17/05	Brokerage Services	33,333
IndyMac Bancorp, Inc.	07/31/08	Bank Holding Company	32,734
Global Crossing, Ltd.	01/28/02	Global Telecommunications Carrier	30,185
Bank of New England Corp.	01/07/91	Interstate Bank Holding Company	29,773
General Growth Properties, Inc.	04/16/09	Real Estate Investment Company	29,557
Lyondell Chemical Company	01/06/09	Global Manufacturer of Chemicals	27,392
Calpine Corporation	12/20/05	Integrated Power Company	27,216
New Century Financial	04/02/07	Real Estate Investment Trust	26,147
Adelphia Corporation	06/30/02	Cable	24,400

Source: <http://BankruptcyData.com>

⁷ Venuti, E. 2004. "The Going Concern Assumption Revisited: Assessing a Company's Future Viability,": The CPA Journal, <http://www.nysscpa.org/printversions/cpai/2004/504/p40.htm>

With the increase in business bankruptcy filings up so dramatically in terms of dollars and occurrences and with the Public Company Accounting Oversight Board (PCAOB) declaring the non-consideration of a GCO a major audit shortcoming, it is imperative that auditors and management have better tools in determining the requirement for a GCO.⁸

Figure 1: Going Concern Opinions Per Year



Source: Audit Analytics, <http://www.complianceweek.com/s/documents/aagoingconcern.pdf>
*Based on 15,346 audit reports for 2008.

⁸ Public Company Accounting Oversight Board (PCAOB), "Inspection Reports," http://www.pcaob.org/Inspections/Public_Reports/index.aspx

McKenna also shows that the number of GCO's has increased, but has not kept up with the increase in the number of business bankruptcies cited earlier.⁹

Table 3: Going Concern Nine Year Review

Going Concern Nine Year Review (Calendar Year 2008 Estimated)									
	2000	2001	2002	2003	2004	2005	2006	2007	2008
Going Concerns	2805	3065	2901	2617	2600	2747	2924	3293	3128
Total Auditor Opinions	16676	15954	15656	17484	16390	16296	15888	15773	14641
% of All Opinions	16.82%	19.21%	18.53%	14.97%	15.86%	16.86%	18.40%	20.88%	21.36%

V. Issues

There are a number of significant issues regarding the issuance of a GCO. First, history has shown that auditors often have missed the issuance of a GCO regarding companies that they audited as noted above. Secondly, and this may be a reason that auditors have failed to issue a GCO, there are no 'Bright Lines' or absolute thresholds upon which auditors or management may make a GCO decision.¹⁰ Rather, such decisions remain subjective rather than objective in nature. As people will determine a set of facts in

⁹ McKenna, F. (2009, September 18). "Going Concern Audit Opinions: Why So Few Warning Flares". <http://retheauditors.com/2009/09/18/going-concern-audit-opinions-why-so-few-warning-flares/>

¹⁰ Bright lines are quantifiable thresholds upon which a decision may be based. Please see: <http://law.jrank.org/pages/4871/Bright-Line-Rule.html>. Bright Line concepts and thresholds are used throughout Generally Accepted Accounting Principles regimes. For instance, FAS 13, Accounting for Leases, establishes Bright Lines for Bargain Purchase Options as well as Economic Life measurements. <http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175818759901&blobheader=application%2Fpdf> The U.S. Securities and Exchange Commission also established Bright Lines relative to its Segment Reporting requirements. <http://www.sec.gov/rules/final/33-7620.txt>

different ways, this shortcoming is an issue regarding GCO determinations. And lastly, there is the issue of a '*self-fulfilling prophecy*'.¹¹ That is, by issuing a GCO, does that issuance then drive the entity into bankruptcy as no party will further do business with the entity as they now believe it will likely fail.

Based upon these issues, it is believed a '*Bright Line*' methodology based upon '*Inflection Points*' needs to be developed in order to help in making a GCO determination.

VI. Methodology:

The authors examined two published algorithms and a new one developed by one of the authors to see if these algorithms when applied as modified by the authors, could discern material changes ('*Inflection Points*') in corporate financial health before such entities entered bankruptcy. In this regard, companies that entered bankruptcy were chosen to see if such a

11. Merton, Robert K (1968). Social Theory and Social Structure. New York: Free Press. pp. 477. This term was crafted by Robert Merton as "a false definition of situation evoking a new behavior which makes the original false conception come true." Merton's term stems from the Thomas theorem, which states that "If men define situations as real, they are real in their consequences." See Thomas, W. I. (1928). The Child in America: Behavior Problems and Programs. New York: Alfred A. Knopf. pp. 572.

decline in corporate financial well-being could have been detected materially before the bankruptcy filing thereby assisting the auditor in making a GCO.

In this regard, an Altman Z Score Bankruptcy algorithm was used, and a Chanos algorithm was applied with a new purpose.¹² In addition to these two algorithms, another new algorithm, a modification of Altman's basic algorithm was developed and employed. Each of the algorithms detected material changes in corporate financial health before a bankruptcy filing, a complete corporate breakup, or the issuance of a GCO, with the newly developed algorithm in many cases identifying a higher degree of change in score period over period.

The three algorithms are as follows:

1) Altman (Z Score): Basic Algorithm for Public Manufacturing Companies:

$X1 + X2 + X3 + X4 + X5 = Z \text{ Score where:}$

$X1 = \text{Working Capital} / \text{Total Assets} \times .012$

$X2 = \text{Retained earnings} / \text{Total Assets} \times .014$

$X3 = \text{EBIT} / \text{Total Assets} \times .033$

$X4 = \text{Market Value of Equity} / \text{Total Debt} \times .006$

¹² Altman, Edward; Edith Hotchkiss (2005). Corporate Financial Distress and Bankruptcy, 3rd edition. John Wiley and Sons. Altman has developed a number of 'Z Score' algorithms based on industry and whether the entity is public or private. James Chanos is an American billionaire and hedge fund manager, and is president and founder of Kynikos Associates, a New York City investment company that is focused on short selling. Previously, it was disclosed that one tool Kynikos uses in its analyses is the Chanos Algorithm cited below and identified as a 'C' Score. The third algorithm, a modification of Altman's was developed by Igor Pustylnick, an Affiliated Professor of Finance at the Swiss Management Center, Zurich and identified in the tables as the 'P' score algorithm.

$$X5 = \text{Sales} / \text{Total Assets} \times .999$$

For scores above 3.0, bankruptcy is not likely. For scores of 1.8 or less, bankruptcy is likely. A score between 1.8 and 3.0 is the gray area. Altman has been shown to be able to predict bankruptcy 95% of the time one year out and 70% of the time within two years. Altman has tailored the above basic 'Z Score' algorithm for different industries.

2) Chanos (C Score) Algorithm:

$$\frac{\text{Working Capital} + \text{Retained earnings} + 12 \text{ Month Trailing EBIT} + 12 \text{ Months Trailing Revenue}}{12 \text{ Month Average Total Assets}}$$

While scores differ using Chanos versus the Altman or Pustylnick algorithms, they trend in the same direction. That is, when Altman and Pustylnick scores go up or down, so do the Chanos scores.

3) Pustylnick (P Score) Algorithm:

$$P = 1.2 * X1 + 1.4 * X2 + 3.3 * X3 + 0.6 * X4 + 1.0 * X5, \text{ where}$$

$$X1 = \text{Shareholders' Equity} / \text{Total Assets} \times 1.2$$

$$X2 = \text{Retained earnings} / \text{Total Assets} \times .014$$

$$X3 = \text{EBIT} / \text{Total Assets} \times .033$$

$$X4 = \text{Market value of Equity} / \text{Total Debt} \times .006$$

$$X5 = \text{Revenue} / \text{Total Assets} \times .999$$

Table 4: Application of Algorithms to Selected Companies Filing for Bankruptcy or Breakup (AT&T)

Company Name	Year	Z Score	C Score	P Score
General Motors	2007	-0.85	0.67	0.42
	2006	-0.12	0.13	0.07
	2005	-0.30	0.41	0.33
Adelphia	2000	0.12	0.54	0.63
	1999	0.17	0.57	0.68
	1998	-0.99	-0.96	-1.50

	1997	-1.22	-1.28	-1.90
Global Crossing	2000	-0.22	0.54	0.64
	1999	0.23	0.67	0.96
	1998	0.46	0.59	0.86
Calpine Corporation	2004	-0.02	0.54	0.54
	2003	0.15	0.57	0.64
	2002	0.02	0.58	0.65
AT&T	2001	-0.05	0.65	0.72
	2000	-0.04	0.78	0.94
	1999	0.20	0.93	1.21
	1998	0.67	1.55	2.00
	1997	0.62	1.48	1.90

VII. Analysis of the Facts

Each of the above three algorithms (Z, C, and P Scores) when applied to the financials of the selected companies shown above indicated a decline in corporate financial health (determined by a decrease in overall score) from prior years to the last year measured preceding bankruptcy or breakup, with the exception of the C and P scores for General Motors in the last year shown (2007). Such consistency with the noted exception indicates that algorithms can likely be developed, or the above algorithms modified, based on industry specific models to yield a *'Bright Line'* or *'Inflection Point'* that would trigger an auditor GCO being required to be issued.

Clearly, a much bigger sample of companies should be chosen and the algorithms applied to this larger class in order to better validate the

changes detected herein. However, it appears from this selected sample that algorithms such as applied in this paper have predictive value as to changing corporate financial health that can be used on a prospective basis.

VIII. The Referendum

What is missing in the algorithm scores is the definition of a '*Bright Line*' or '*Inflection Point*' that could trigger the requirement for an auditor GCO. That is, once a company's financial information crosses some algorithmic threshold, a GCO should be required to be made by the auditors. Or conversely, the auditors should have to state why a GCO was not being issued.

Altman's 'Z Score' model provides a range of thresholds with a large grey area, while the 'P' and 'C' scores do not offer any threshold metrics.¹³ The development of industry specific algorithms could be tailored for each industry much like the Enhanced Business Reporting Consortium Model (EBRC), where industry specific Key Performance Indicators (KPIs) are being developed.¹⁴

¹³ The absence of absolute 'Bright Lines' or Inflection Points is not a shortcoming of the models as they were developed for other purposes.

¹⁴ Enhanced Business Reporting Consortium (EBRC) is a professional organization that has as its mission 'Transparent Financial Reporting.' <http://www.ebr360.org/> One of the activities the EBRC is presently undertaking is the development of specific 'Key Performance Indicators' (KPIs) for specific industries. These KPIs will be

Moreover, like Altman, perhaps a range of values could be established based on the algorithm chosen and accepted as the standard that would require the auditors to issue a GCO warning something akin to: "Based upon an examination the Company X's financial statements for the periods ending December 31, 20X1 and 20X2 and the application of the Financial Accounting Standards Board (FASB) specified algorithm as defined in FAS XXX, a Going Concern Opinion is required to be issued." This GCO could then be further explained relative to Company X's ability to continue to operate in future periods based upon the statistical validity of the FASB approved algorithm.

IX. Conclusion

Bankruptcies in the U.S. are of major concern to all. They have had a major impact on the U.S. economy. Going Concern Opinions in a majority of cases have been absent in companies that subsequently filed for bankruptcy. The PCAOB has highlighted this auditor shortcoming in auditors being remiss relative to the issuance of GCOs in the execution of their audits, and the public has been less than fully informed by their absence as well.

financial measures that are to be included in financial reports such that one business in an industry may be better and more accurately compared with another business in that same industry.

In order to better make a GCO decision by management and the auditors, an objective '*Bright Line*' or '*Inflection Point*' threshold is needed. That is, auditor decisions in this matter need more of an objective quality versus the subjective measures used presently. In this regard, three algorithms were examined and applied to companies' financials where the respective company went into bankruptcy or was broken up and the pieces sold off. While these algorithms were not designed to signal a '*Bright Line*' or '*Inflection Point*', indications are that these algorithms, or modifications or variants of these algorithms, may serve to identify the threshold where a GCO should be issued. Clearly, a larger application of the algorithms to more companies filing for bankruptcy is needed. Moreover, modifications to these algorithms appear warranted in order to more precisely establish '*Bright Lines*' or '*Inflection Points*' in reaching GCO determinations, and algorithms should be tailored to specific industries to make them as accurate as possible.

Auditors should be protected from liability relative to the issuance of a GCO based upon accepted GCO determinants ('*Bright Lines*' or '*Inflection Points*'). That is, if the auditor accurately makes a GCO measurement based upon accepted GCO '*Bright Lines*' or '*Inflection Points*', the auditor should be held harmless for any resulting financial or operating consequences. This is

particularly important because of the '*self-fulfilling prophecy*' phenomenon presented earlier.

X. Recommendations and Areas for Future Research

Clearly a large sample of companies filing for bankruptcy should be examined and segmented along industry lines similar to what the EBRC is doing with its KPI developments. Also, the above algorithms, modifications to these algorithms, and variants should be tested to see which work best in identifying the likelihood of business failure. Then '*Bright Line*' or '*Inflection Point*' threshold measurements should be determined so that auditors can make objective decisions regarding the issuance of a GCO – The Referendum.

XI. References

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Douglas, M. 27 Feb. 2009, "United States: The Year in Bankruptcy: 2008," Jones Day. Article may be found at <http://www.Mondaq.com/unitedstates/article.asp?articleid=75256>

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XI. Key words

Bright Lines, Inflection Points, Going Concern Opinions, GCOs, EBRC, Self-fulfilling prophecies, bankruptcy, PCAOB, KPIs, Algorithms, Chanos, Altman, Pustylnick, SAS 59, P Score, Z Score, C Score, auditor, Referendum