

Going Concern

Evolving Standards and Management's Future Role

By Lawrence S. Burke, CPA

When performing a financial statement¹ audit, the auditor spends a significant amount of time and effort ensuring that the historical financial statements – which management presents on a going-concern basis, in most cases – are in accordance with Generally Accepted Accounting Principles. Going concern is assumed in financial reporting in the absence of significant information to the contrary.

Because most entities operate and report as a going concern, there had been minimal attention paid to the required auditor going-concern assessment process and related decision to issue a going-concern opinion. However, as a consequence of the economic crisis and ongoing weak economy during the past few years, the auditor and management have placed a renewed emphasis on the required going-concern assessment process.¹

As a direct result of the economic crisis, the AICPA issued an Audit Risk Alert, *Current Economic Crisis: Accounting and Auditing Considerations*. It included a section titled “Consideration of an Entity’s Ability to

Continue as a Going Concern.” The Public Company Accounting Oversight Board (PCAOB) issued a Staff Audit Practice Alert, *Audit Consideration in the Current Economic Environment*. It included a section on the auditor’s consideration of a company’s ability to continue as a going concern.

The PCAOB highlighted the guidance in Auditing Standard AU 341A. The standard states that the auditor has a responsibility to evaluate if there is substantial doubt about an entity’s ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements. The auditor’s evaluation is based on his or her knowledge of relevant conditions and events that exist at or have

occurred prior to the date of the auditor’s report. The PCAOB also included a list of “conditions and events that, when considered in the aggregate, indicate there could be substantial doubt about the company’s ability to continue as a going concern for a reasonable period of time.” They include:

- Negative trends – for example, recurring operating losses; working capital deficiencies; negative cash flows from operating activities; adverse key financial ratios
- Other indications of financial difficulties – for example, default on loan or similar agreements; arrearages in dividends; denial of usual trade credit from suppliers; restructuring of debt; noncompliance with statutory capital requirements; need to seek new sources or methods of financing to dispose of substantial assets
- Internal matters – for example, work stoppages or other labor difficulties; substantial dependence on the success of a particular project; uneconomic long- >>>

term commitments; need to significantly revise operations

- External matters that have occurred – for example, legal proceedings, legislation or similar matters that might jeopardize a company’s ability to operate; loss of a key franchise, license or patent; loss of a principal customer or supplier; uninsured catastrophe such as a drought, earthquake or flood

Although each of these indications are intended to be part of the auditor’s consideration as part of the going concern assessment, AU 341A also requires that the auditor obtain evidence and feedback from management – which, understandably, can be biased. As part of the going-concern assessment, the auditor is required to use subjective judgment because neither the auditor nor management ultimately can predict the future.

Although such judgment is based on audit evidence, it still can differ from management’s perspective, especially in light of the current economic uncertainty. In those cases, a controversial situation could arise between the auditor and management.

The auditor has an imposed obligation to perform an assessment that many feel should reside with management.

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academic studies have found audit firms have made going-concern qualifications for just over half of the companies that go bankrupt, according to Joseph Carcello, a University of Tennessee professor who sits on the PCAOB’s advisory group.

In 2008, the Financial Accounting Standards Board (FASB)² issued an exposure draft (ED) titled *Going Concern*. It clarifies that an entity and its respective management shall have the primary responsibility for assessing its ability to continue as a going concern. The initial *Going Concern ED* was not without controversy. Several areas generated feedback from respondents.

The ED defines the time horizon during which an entity shall evaluate its ability to continue as a going concern as “at least, but not limited to, 12 months from the end of the reporting period.” This is consistent with the time horizon in International Accounting Standard (IAS) 1. However, this definition is not consistent with the time horizon used in AU 341, which is defined as not to exceed one year beyond the date of the financial statements.

After considering respondents’ comments about the initial ED, the FASB has recommended the time horizon during which management shall take into account available information generally will be 12 months from the end of the reporting period. However, certain events that are expected to occur or are reasonably foreseeable beyond the 12 months, and would materially affect the assessment, are considered part of the time horizon.

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new FASB-recommended time horizon was based on the concept of avoiding the issues associated with a bright-line time horizon test. The current recommendation is more in line with a principles-based approach. However, in discussing the new time-horizon recommendation, the FASB stated that it does not intend for the assessment of the period beyond a year to be open ended or indefinite.

The FASB also did not elect to specifically define a going concern. Instead, the FASB recommended that the following required disclosures be made when “management, applying commercially reasonable business judgment, is aware of conditions and events that indicate, based on current facts and circumstances, that it is reasonably foreseeable that an entity may not be able to meet its obligations as they become due without substantial disposition of assets outside the ordinary course of business, restructuring of debt, issuance of debt, issuance of equity, externally or internally forced revisions of its operations or similar actions.

- a. Pertinent conditions and events giving rise to the assessment, including when such conditions and events are anticipated to occur, if reasonably estimable
- b. The possible effects of those conditions and events
- c. Possible discontinuance of operations
- d. Management’s evaluation of the significance of those conditions and events and any mitigating factors
- e. Management’s plans to mitigate the effects of the conditions and events, whether those plans can be effectively implemented, and the likelihood that such plans will mitigate the adverse effects.

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- f. Information about the recoverability or classification of recorded asset amounts or the amounts or classification of liabilities.”

Other ED-respondent comments addressed the adoption and application of the liquidation basis of accounting. Accordingly, during its public Going Concern project meeting deliberations, the FASB recommended that following principle based guidance be used:

1. “An entity should prepare financial statements on the going concern basis unless liquidation is imminent. Liquidation is imminent if (a) a plan of liquidation has been approved by the entity’s owners or (b) the plan to liquidate is being imposed by other forces and it is remote that the entity will become a going concern in the future. If liquidation is imminent, an entity’s financial statements shall be prepared on a liquidation basis.
2. Liquidation basis financial statements should reflect relevant information about the value of an entity’s resources and obligations in

liquidation. Such financial statements should consist of a *Statement of Net Assets in Liquidation* and a *Statement of Changes in Net Assets in Liquidation*. An entity that applies the liquidation basis of accounting should measure the items in its financial statements to reflect the actual amount of cash that the entity expects to collect or pay during the course of liquidation. This measurement should include, but is not limited to, recognition of (a) costs to dispose of assets or liabilities and (b) expense and income to be incurred through liquidation. The measurement bases and significant assumptions used should be disclosed.”

The FASB is expected to reissue the *Going Concern ED* in the fourth quarter of 2010 for additional public comment with the intent of having it finalized in the first quarter of 2011. It is expected that the updated *Going Concern ED*, once finalized, will clarify to the financial-statement users that management, and not the auditor of an entity, is primarily responsible for assessing the going concern of their respective entity. **FCT**

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ⁱ Note: This article does not address GASB No. 56, which requires management of governments to address going concern issues.
¹ In March 2009, the Governmental Accounting Standards Board (GASB) issued Statement No. 56, *Codification of Accounting and Financial Reporting Guidance Contained in the AICPA Statements on Auditing Standards*, which established accounting and financial reporting standards for relate-party transactions, subsequent events, and going-concern considerations for all state and local governments. As it relates to going concern considerations, this standard states preparers of financial statements for state and local governments “have a responsibility to evaluate whether there is substantial doubt about a government’s ability to continue as a going concern for 12 months beyond the financial statement date.” In addition, the standard requires preparers to consider information that is currently known to the government that may raise substantial doubt shortly after this 12-month period and site as an example “within an additional three months.” The requirements of Statement No. 56 were effective upon its issuance.
² See footnote 1 for a discussion of the requirements for preparers of financial statements for state and local governments.



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