The new requirements relating to going concern evaluation and disclosure provide a critical improvement to the financial statements taken as a whole

Achraf A. Seyam
Sharon Brickman
Borough of Manhattan Community College, New York, USA

Keywords
Going concern, substantial doubt, continuing business, operating loss, defaulting on loans, legal proceeds, interim assessments, cessation of business.

Abstract

The going concern principle assumes that an entity will continue to exist into the future. This assumption implies that the entity will not be compelled to end their operations, liquidate their assets, or go into bankruptcy. It is an integral assumption in financial statements since it allows for the deferral of recognition of certain expenses until a period of time into the future, when the company is still assumed to exist. Members of management, as well as financial statement auditors, are required to identify signs that could indicate that an entity will not be able to continue their operations into the near future. Some of these signs include a trend of operating losses, loan defaults, legal proceedings against the entity and so forth. The Financial Accounting Standards Board (FASB) updated the going concern guidelines so that issuers of financial statements are uniform in frequency and substance of going concern determination. Prior to the Accounting Standards Update, U.S. GAAP lacked sufficient guidance about management's responsibility to evaluate whether there is substantial doubt of the entity's ability to continue as going concern. In order to clarify the uncertainty, FASB issued a new financial reporting standard. This new reporting will be in effect for the annual period ending after December 15, 2016. The updated standard will require management to perform annual and interim assessments of an entity's ability to continue as a going concern for one year from the date of financial statements issuance.

Introduction

The going concern principle is a fundamental financial statement assumption that assumes an entity will remain in business for the foreseeable future. Remaining in business means that the entity will not be compelled to end their operations, liquidate their assets, or go into bankruptcy. The going concern principle plays a major role in the accounting standards that allow for the deferral of recognition of expenses and revenue. Since the business is assumed to continue to exist into the future, delayed recognition may be appropriate under certain circumstances. If the business shows signs that it is not in the position to be assumed to continue to exist into the near future, this is known as going concern risk. Some of these signs may include a trend of operating losses, defaulting on loans, legal proceeds against the entity and so forth.

Objective of the Study

Until recently, the going concern assumption was just that—an assumption. Management was not required to perform specific procedures or to make any express statements on the matter. But when preparing financial statements for each reporting period, management should, in fact, have provisions in place to analyze if there are conditions or events present that may prevent the entity from continuing business one year from the financial statement date. The objective of this paper is to inform preparers of financial statements of the changes to the requirements for presentation of financial statements as it relates to going concern. More specifically, if conditions or events raise substantial doubt that the entity will continue to exist, a statement should be attached to the report to inform the reader of the events that may cause the cessation of business.

Changes to the Accounting Standard

Accounting standards are constantly changing to keep up with the demand of an ever-changing market. The topic of going concern, specifically, the requirements for evaluation and disclosure, is no different. U.S. Generally Accepted Accounting Principles (US GAAP) had not provided guidance regarding evaluation and disclosures of going concern matters. As a result, companies had the ability to be inconsistent and/or incomparable with their peers in whether, when, and how management discloses the condition of the company. Additionally, management had the ability to potentially prepare financial statements that did not show the true colors of the company.

In contrast, Generally Accepted Auditing Standards (GAAS) has historically required financial statement auditors to perform procedures to evaluate if there is substantial doubt that the entity has the ability to continue as a going concern, although, the definition of "substantial doubt" had not clearly been defined. Auditors use their professional judgment on this very subjective matter. Auditors using professional judgment in this and other areas make reasonable decisions based on various facts and circumstances, although it does leave room for interpretation. It is possible for different auditors to make different decisions and conclusions with the same underlying facts and circumstances. This results in the potential for a lack of comparability among entities. Additionally, if the auditors find, based on their procedures that the entity raises substantial doubt about its ability to continue to operate as a going concern, the conclusion is often in disagreement with management, since the auditors performed specific procedures that were prescribed to them and used their professional judgment, while management had not performed any procedures. Without US GAAP providing principles and guidance for management, this clash would continue.

The Financial Accounting Standards Board (FASB) has been in deliberation for a period of time regarding the guidelines for preparers of financial statements related to the going concern matter. In 2008, there was an initiative to require entities to incorporate specific provisions with regard to financial reporting when an entity's future is of suspect, and the FASB issued an exposure draft to provide entities with guidance in this area. This exposure draft attempted to reconcile guidelines from both Generally Accepted Auditing Standards (US GAAS) and International Financial Reporting Standards (IFRS).

This original exposure draft elicited criticism for the terminology used, and it was suggested that the terms "going concern" and "substantial doubt" were not defined clearly enough. There was further criticism regarding the lack of guidance for preparation of financial statements when an entity is in liquidation. In 2010, after reviewing those criticisms, the board defined the meaning of going concern as: an early warning disclosure about an entity's uncertainties. In 2013, the board issued a second exposure draft which suggested the requirement of disclosures when it was more likely than not that an entity would be unable to meet its obligations within twelve months after the financial statement date or if it is probable that the entity would be unable to meet its obligations within 24 months after the financial statement date. These disclosures would be known as early warning disclosures.

The next step was to set the guidelines for what exactly substantial doubt is with regard to an entity's future. The board defined substantial doubt as a high threshold leading to high uncertainty that the entity will be able to meet its obligations. This guideline, relating to an entity meeting its obligation, was used, since it is the most familiar and understandable threshold. Other alternatives were considered i.e. assessing the probability of impending liquidations or existing conditions that would interfere with the entity's ability to realize its assets and meet its obligations. But the most familiar threshold was chosen.

Additional amendments to the original exposure draft gave management the responsibility to evaluate when and how to disclose substantial doubt that an entity will continue as a going concern. The board discussed various options with regard to frequency of evaluation. The option that was chosen was that the entity's management should evaluate going concern risk at each annual and interim reporting period. This was the most popular option among respondents to the 2013 exposure draft. Other options that were discussed were annual only or annual only with triggering event-based interim evaluations. The latter two were not selected, since they do not provide a comprehensive evaluation for each interim period.

The more controversial issue the board discussed was the *how* i.e. the actual evaluation of substantial doubt. At what point must an entity disclose the uncertainty that they will be able to continue as a going concern? The board's research found that many financial statement users think of substantial doubt using stricter threshold than management. They found that financial statement users tend to think that substantial doubt means that there is a high probability that the entity will go bankrupt.

As a response to criticism to the exposure draft regarding the explanation given for what substantial doubt actually is, FASB provided examples of symptoms a company may experience when it is substantially doubtful to be able to continue as a going concern. Those symptoms include recurring operating losses, working capital deficiencies, negative cash flows from operating activities, and adverse key financial ratios. Other indications of possible substantial doubt include defaulting on loans or similar agreements, suppliers denying the entity from buying inventory on account, restructuring of debt, noncompliance with statutory capital requirements, the inability to finance operations or take out loans because of bad credit. Other indications include expensive legal proceedings and litigation, which may put pressure on the company to liquidate assets to meet obligations.

Methodology to Evaluate Going Concern

In order to evaluate going concern, one must use a variety of methods. Some methods include the analysis of key financial ratios for forecasting, the review of compliance with terms of debt agreements, the review of minutes for board of directors meetings and other committee meetings, and the inquiry of the company's legal counsel. Additional methods are evaluating the motivations for new borrowings and raising new capital, liquidation of assets, restructuring costs, and reducing dividends. One must determine if the results of this methodology results in substantial doubt that the company will continue as a going concern.

The New Standard

One of the main provisions included in the board's amendments is that management is now obligated to evaluate whether certain conditions or events raise substantial doubt about the entity's ability to continue as a going concern or continue its operations as a business. The important differentiation is that now *management* evaluates whether the company will be able to meet its obligations. This addresses the goal of having less disparity between management and the auditor in regards to the relevant disclosures.

The board's amendments also included a provision regarding the substance of what going concern is. Before these provisions were established, US GAAP had the assumption that a company will continue as a going concern and operate normal business functions into the future. Historically, the external auditor had the responsibility to report on an entity's capability to continue as a going concern based on the entity's liquidity: the ability for the company to pay liabilities as they become due. This leads to the problem that by the time the external auditor makes his call on the matter, it could already be at the point that the company is close to collapse. Surely, that is not the proper way to make financial statement users aware of the company's financial situation. These going concern evaluations need to be performed sooner, and by management. Results of the evaluation need to be presented in the footnotes and disclosed using a standardized model. The new policies implemented into US GAAP now provide management with a true definition of substantial doubt, in addition to principles and guidance on how the substantial doubt needs to be presented in the financial statements.

The new update includes provisions that instruct management to disclose whether the entity is able to meet obligations due with the company's assets. If management concludes that there is substantial doubt within the entity, they are responsible to inform investors and other financial statement users of such and of their plans to minimize that substantial doubt. These plans should only be disclosed if the plans have reasonable assurance to mitigate the substantial doubt, and if the plans will be carried out to their fullest potential. If management's plans are implemented, and implemented effectively, the entity would be relieved of the substantial doubt to continue as a going concern. In this case, management would be responsible for disclosing all of the facts and circumstances; the existence of substantial doubt, the plans to minimize this substantial doubt, and how the plans effectively took place and alleviated the entity of substantial doubt. This should all be presented in an understandable way to financial statement users. If management's plans are not effective i.e.do not minimize or alleviate the entity of any substantial doubt to operate as a going concern, management is required to provide a statement in the footnotes including the following: existence of substantial doubt, and which events and/or conditions indicated such. Including these relevant disclosures would give financial statement users the full picture with respect to substantial doubt and how the company is affected.

The amendments in this standard, including a few of the main provisions mentioned above, are effective for the annual period ending after December 15, 2016, however, early application is permitted. Therefore in the future, all entities, public and non-public, are required to meet the requirements of the new standard "Accounting Standards Update No. 2014-15, *Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern."*

Accounting professionals are satisfied with the resulting updates to the standard. The Executive Director of the Center for Audit Quality (CAQ), Cindy Fornelli stated, "The CAQ commends FASB for its efforts in developing a standard that provides guidance regarding a preparer's responsibility to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern, and, where required, to provide footnote disclosures about going concern uncertainties each reporting period. I (We) believe the adopted ASU represents an improvement over the current going concern model and will provide users of financial statements with more clarity on the nature of conditions or events that may raise substantial doubt about the entity's ability to continue as a going concern".

Comparison to other Accounting Standards

During this study, it was beneficial to compare the U.S. Generally Accepted Accounting Principles (US GAAP) to the respective accounting standard from other countries. Since the International Financial Reporting Standards (IFRS), issued by the International Accounting

Standards Board, has been adopted by approximately 120 countries, this is the most inclusive comparison. Under IFRS, the standard is essentially the same as the relevant standard under US GAAP, with one exception. While under US GAAP, the guideline requires management to assess whether the company is a going concern for a one year period after the financial statement date, IFRS's assessment period is for *at least* one year. US GAAP's position stems from the desire not to be overly speculative when making the assessment on this matter too far into the future. It comes as no surprise that all other aspects of this US GAAP standard are very similar to the international framework, since US GAAP has recently been making changes to the majority of their standards to conform with IFRS.

Conclusion

Professionals agree that the new requirements relating to going concern evaluation and disclosure provide a critical improvement to the financial statements taken as a whole. The improvements provide for a more complete and accurate picture to financial statement users on a company's financial health. A company's financial statement will now be more comparable to another company's financial statements and investors will have more confidence that going concern risk is being sufficiently addressed. This update will help investors as well as entity management and their auditors. After many years of working through feedback, it appears that the board has finally established proper guidance in this area.

Limitations of the Study

This study is limited to for-profit companies, and it does not address state and local governmental entities. This is such, since governmental entities have unique accounting standards applied, which are developed by the Governmental Accounting Standards Board instead of the Financial Accounting Standards Board. Since they are not profit driven, the going concern assessment will surely be performed using different assumptions and guidelines, but we have not explored that topic in this paper. We look forward to exploring the topic in a future paper.

References

Assurance Services. (2014, August 28). *pwc*. Retrieved from In brief: FASB introduces going concern assessment and disclosure requirements: http://www.pwc.com/us/en/cfodirect/publications/in-brief/fasb-going-concern-us2014-17.jhtml

Center for Audit Quality. (2014, August 27). *Center for Audit Quality*. Retrieved from http://www.thecaq.org/newsroom/2014/08/27/caq-commends-fasb-s-issuance-of-guidance-to-improve-financial-reporting-of-going-concern-entities

FASB Financial Accounting Standards Board. (2014, August 27). *FASB Financial Accounting Standards Board*. Retrieved from http://www.fasb.org/cs/ContentServer?pagename=FASB/FASBContent_C/NewsPage&cid=1176164330187

Financial Accounting Standards Board. (2014, August). Presentation of Financial Statements-Going Concern (Subtopic 205-40). *Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern*, pp. 1-33.

Jim Sylph, Executive Director, Professional Standards IFAC international Auditing and Assurance Standards Board, International Federation of Accountants http://www.ifac.org/system/files/downloads/IAASB_Staff_Audit_Practice_Alerts_2009_01.pdf

Tara Loan Gheorghe THE GOING CONCERN – THEORY AND PRACTICE IN THE FINANCIAL AUDIT University of Oradea, Economic Sciences Department. http://anale.steconomiceuoradea.ro/volume/2011/n2/089.pdf

Tysiac, K. (2014, August 27). *Journal of Accountancy*. Retrieved from FASB defines management's going-concern responsibilities: http://journalofaccountancy.com/news/2014/aug/201410841.html

Ward, D. (2014, October 24). *Brown Smith Wallace* . Retrieved from The Ball is in Your Court: Management to Assess Going Concern Issues: http://bswllc.com/the-ball-is-in-your-court-management-to-assess-going-concern-issues/