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Conflicting Requirements for Addressing "Going Concern" Situations Will Impact Financial Reporting by Both Private and Public Companies

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The allocation of responsibilities between company management and outside auditors has long been clear. Management is obligated to develop and implement an accounting system, including pertinent internal controls, to enable the proper and timely recognition, measurement, classification, and recordation of transactions and events bearing upon the entity's financial position and results of operations, and the periodic preparation of financial statements that present those matters fairly, in accordance with U.S. GAAP or other basis of accounting. Auditors, on the other hand, have been responsible for examining the entity's financial statements and rendering a professional opinion thereon. Auditors do not create the financial statements, nor do they make the estimates and other judgments that affect the amounts or classifications reported (although they often do consult management regarding allowable methods and measurements, if management makes the actual decisions after being so educated).

It has also been the case, for many decades, that there was one glaring exception to this division of responsibility: the auditors have been assigned the duty to assess whether the reporting entity was expected to survive for at least one year from the balance sheet date – and if they concluded there was "substantial doubt" about the reporting entity being able to continue as a "going concern," to call out that fact in the auditors' report. In such instances, management also needed to address this issue in the notes to the financial statements, including a narrative regarding its plans to avoid the fate of business failure. If management omitted this discussion, the statements would be doubly damned by the auditors – the failure to make the informative disclosure would have to be cited, as well as the fact of a going concern uncertainty. In practice, management rarely raised the going concern issue, but rather reacted to facts (such as persistence of losses, negative cash flow from operations, lack of working capital, or violation of loan covenants) uncovered during the audit.

This anomaly will soon be eliminated, at least for non-public companies (i.e., those whose audits are not overseen by the Public Company Accounting Oversight Board – PCAOB), because, for the first time, assessment of going concern status will be required to be performed by management of the reporting entity. FASB recently enacted a standard that will require that management, as part of the regular process of preparing financial statements, evaluate whether the entity is likely to survive; the auditors will then be responsible for evaluating management's process for making this assessment and the conclusions that were reached. (Note that FASB cannot dictate auditors' duties, and the responsible audit standard setter for privately-held companies, the AICPA's Auditing Standards Board, has yet to enact revised guidance, but it is reasonable to assume that it will conform its audit requirements to the new accounting standard.)

Interestingly, the FASB requirement is that management assess survivability for one year from the date of *issuance* of the financial statements, whereas the auditors' obligation under still-effective AU-C §570 is to assess whether the reporting entity will survive for one year from the *balance sheet date*. It was not unheard of, under current rules, for privately-held companies threatened with the inclusion of a going concern emphasis of a matter paragraph in its auditors' report to delay issuance of the financial statements until some or most of the following year had elapsed, to demonstrate its ability to survive and

thus obviate the need for the auditors' inclusion of "substantial doubt" language in the report. Under the new FASB rules (not mandatorily effective until years ending after December 15, 2016, although earlier application is permitted), any delay in issuing the financial statement will only move the assessment horizon out further (although, if management has used the extra time to resolve the matter giving rise to that going concern, the delay might still prove to be useful).

PCAOB has thrown, if not a monkey wrench, at least a conundrum into the equation. It has just announced (in Staff Audit Practice Alert No. 13) that, for audits of "issuers" (i.e., public companies), it will continue to prescribe AU §341, which it embraced as its "interim" auditing standard at the Board's creation and has never seen the need to supersede with a standard of its own devising. This raises a number of issues for reporting entities and auditors, the most important of which revolve around two concerns. The first is the one cited above: the one year survivability evaluation runs from the statement issuance date under the FASB standard with which management must comply – and the auditors' duty will continue to be to evaluate whether the financial statements have been fairly presented *in accordance with GAAP*. By the same token, the auditing standards imposed by PCAOB (as they were adopted from the AICPA's codification as it existed in 2002 when the PCAOB was formed) will require that the auditors evaluate going concern for one year from the balance sheet date.

Perhaps more important, but somewhat more subtle, is the second likely source of conflict. Under auditing standards, the threshold issue is "substantial doubt," which is undefined in the literature, but in practice has been applied as if it meant a likelihood of no more than 50%, and probably much less. In other words, if auditors perceive that the reporting entity is facing serious threats, even if the likelihood that it will succumb to them is somewhat under 50%, they generally err on the side of conservatism and impose "going concern" language on the report. (However, auditors are not terribly successful at making these assessments: only about one-half of companies filing for bankruptcy were given a going concern modification within the preceding twelve months.)

The new accounting standard, however, uses the venerable "probable" threshold for the mandatory disclosure of a going concern uncertainty by management. In contrast with "substantial doubt," "probable" is defined, albeit still somewhat imprecisely, in longstanding financial reporting literature (pertaining to recognition of contingent losses), and has been quantified in practice as being in the range of at least a 85% likelihood, if not higher. In other words, management of a public company, following the new FASB standard, will be required to disclose its concerns if it determines that there is a likelihood of not continuing in existence for one year from the statement issuance date of about 85%, which is a high threshold. The auditors of that company, however, will have to assess going concern implications if perceived to raise "substantial doubt," which at most is roughly comparable to the "more likely than not" criterion found elsewhere in the accounting literature – defined as a likelihood just over 50%.

Consider this situation: management intends to issue the calendar 2014 financial statements on March 5, 2015, and it assesses the likelihood of business failure before March 5, 2016, as being about 60% due to profitability and liquidity problems. This would *not* require disclosure under the new FASB rules. However, the auditors assess the risk of business failure at 40% through December 31, 2015, and under PCAOB AU §341 would demand that management address this in the financial statement footnotes, and would impose going concern language in the auditors' report. Management following FASB rules would argue against the disclosure, but would either acquiesce with the auditors' demand or be given a further qualification for inadequate disclosures.

It remains to be seen how this divergence will be resolved in practice, and in the meantime PCAOB indicates that it has a standards-setting agenda project to consider development of its own audit guidance. In the near term, however, the conflicting thresholds may serve to dissuade companies from early adopting the new FASB standard.

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