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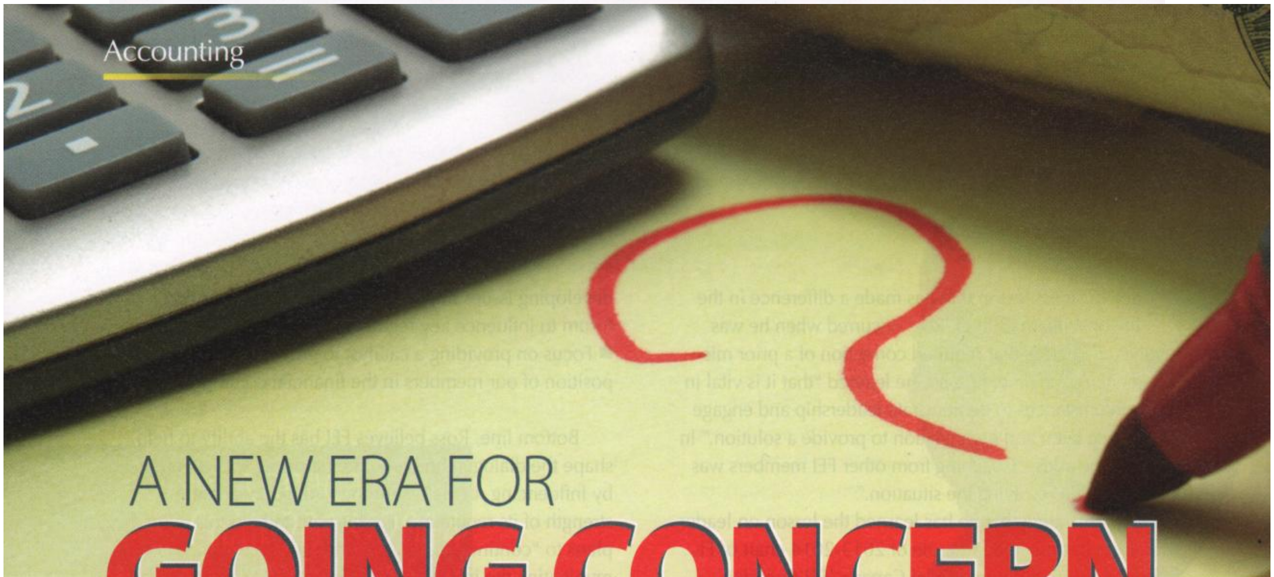

Accounting

A NEW ERA FOR GOING CONCERN

By Wayne Pinnell

Should the FASB's proposed new standard be approved, it would represent a significant step toward placing the burden of assessing and reporting going concern issues on management. Yet the management/auditor relationship will remain a cornerstone.

The financial crisis of 2008 shone a garish, bright light on the reporting shortcomings of some of the most powerful companies in the United States. With automakers, homebuilders, retailers and financial companies running low on cash and high on uncertainty, auditors worked feverishly to convince management teams to add footnote disclosures and clarifications about their clients' ability to continue operating as a "going concern" (i.e., a company that has the resources needed to continue to operate indefinitely).

Meanwhile, the majority of the companies filing for bankruptcy had not published any warning in their financial statements in the year prior to the crisis.

This financial upheaval stoked an ongoing conversation about who is really responsible for assessing and reporting about a company's ability to continue as a going concern. Should an external auditor be charged with making early-stage assessments of a client's financial viability, or should this responsibility lie with management?

Heretofore, the only guidance on this issue had been embedded in generally accepted auditing standards — the "rules" by which audits are performed. On June 26, 2013, the Financial Accounting Standards Board (FASB) issued a proposed accounting standards update (ASU) that may ultimately tip the scales toward management. However, questions remain about the proper implementation of such a standard, should it be approved.

The Proposal

The FASB proposal recommends that management be required to perform interim and annual assessments of their company's ability to operate as a going concern for a 24-month period. In addition to public companies, private companies and non-profit organizations would also fall under the jurisdiction of this standard. This responsibility had previously been in the court of the auditor.

Unfortunately, U.S. GAAP does not provide any specific requirements to disclosing uncertainties with going concern, leading to many disparate methodologies and practices for assessing the nature, timing and extent of the entity's disclosures.

Under the FASB proposal, management would be required to disclose if it is apparent that the company is more likely than not (i.e., a likelihood exceeding

50 percent) to be unable to meet its obligations within 12 months or it is known or probable that it will be unable to meet its obligations within 24 months without proactive changes to its ordinary course of business.

Should financial difficulties be determined based on the guidance of this proposed ASU, the entity would be required to provide footnote disclosures describing the events that led to its inability to meet its obligations, the potential effects of the events on the entity, management's evaluation of their significance, mitigating conditions and any plans to address the issue.

The proposal provides the following examples of events that may prevent an entity from meeting its obligations, which are paraphrased below:

1. **Negative trends**, such as recurring operating losses, working capital deficiencies, negative cash flows from operating activities and adverse key financial ratios.
2. **Indications of possible financial difficulties**, such as a default on loans, arrearages in dividends, denial of usual trade credit from suppliers, restructuring debt to avoid default, noncompliance with statutory capital requirements and a need to seek new financing methods to dispose of substantial assets.
3. **Internal issues**, such as labor disputes, overdependence on one particular project and a need to make significant changes or revisions to operations.
4. **External matters**, such as legal proceedings, legislation, loss of licenses or patents, loss of key customers or suppliers and natural disasters.

FASB believes that extending the responsibility for evaluating going concern from auditors to management will achieve two key objectives. First, it will enhance the timelines, clarity and consistency of related disclosures. Second, it will improve convergence with International Financial Reporting Standards (IFRS), as IFRS and the Public Company Accounting Oversight Board (PCAOB) are also moving toward more comprehensive reporting standards by which to determine risks related to going concern.

Though the investment community favors both overhauling the standards for assessing going concern and placing more responsibility on management, the proposal poses several key questions for CFOs and other senior-level management, beginning with the auditor/management relationship.

This ASU will certainly play well among the investment community, where a growing chorus of disenchantment with consistency and accuracy is increasing in volume and frequency.

A Sept. 12, 2012 report in *The Wall Street Journal* asserts: "Auditors have varied significantly from year-to-year in their ability to use the going concern opinion as a warning to investors over the past few years. Market shifts have led to more rapid bankruptcies that are not as easy to detect 12 months in advance. Also, as auditors have grown more worried about their legal liability, they have been seen as less willing to give out negative going concern opinions that might make bankruptcy inevitable once they are issued."

The report goes on to cite a 2008 Duff & Phelps study that found 63 percent of medium and large companies that filed for bankruptcy during the year had not received a going concern warning from their auditor.

A number of investors have since come forward and expressed that current standards for going concern are inconsistent and ineffective, including Anne Simpson, head of corporate governance at the California Public Employees Retirement System (CALPERS). In a March 2012 Reuters story, Simpson said: "The current definition of 'going concern' means you're pretty much over the edge of the cliff — it's almost too late to do anything."

With the investment community overwhelmingly in favor of both overhauling the standards for assessing going concern and placing more responsibility on management, the FASB proposal is a welcome breath of fresh air. However, the proposal does pose several key questions for chief financial officers (CFOs) and other senior-level management, beginning with auditor/management relationship.

The following questions are expected to guide the comment period and further shape how FASB sets the standard for assessing going concern.

How will the proposed ASU eliminate inherent conflicts between auditors and management in "close-call situations?"

Historically, assessing and reporting going concern issues has been characterized by an inherent conflict of interest between the priorities of management and the auditor. Management may lean toward presenting their company's financial statement in the "best light" to ensure ongoing investment and access to capital.

Conversely, the auditor's role has been to mitigate information risk so that users of financial statements have a credible, fair presentation of a company's operations and financial position on which to make investment or credit decisions. In other words, the auditor acts as a credibility middle man between the story management wants to tell and what the user of the financial statement should believe using GAAP as the framework.

Shifting the responsibility for assessing and reporting going concern to management will not eliminate this conflict, but it may set the stage for giving management the necessary guidance to perform more objective analysis and prepare more accurate, informative disclosures. However, the auditor will still play an essential role in ensuring that management's assessment is objective and, ultimately, fairly stated.

How will the auditor relationship be structured on a go-forward basis?

If assessing going concern were a sport, management has historically acted as the defense. The auditor would perform the analysis and present its findings to management, which would then be responsible for addressing and/or rebutting any information that may suggest potential issues with going concern.

Under the proposed new standard, management's role would shift to the offense. Management would prepare its analysis earlier in the process and act proactively in assessing and presenting its findings to the auditor. The auditor, in turn, would review and potentially challenge management's analysis through Q&A and the auditor's own observations.

While the audit itself will not likely change, there is potential that these discussions and analyses could happen earlier in the game — not in overtime when everyone is trying to beat the clock.

Unfortunately, U.S. GAAP does not provide any specific requirements to disclosing uncertainties with going concern, leading to many disparate methodologies and practices for assessing the nature, timing and extent of the entity's disclosures.

What can companies do to adequately prepare for this potential change while it is still in the proposal stage?

To accurately assess going concern, management may be required to review and overhaul its internal forecasting, strategic planning and risk assessment modules. By performing more in-depth financial analysis, management will become better equipped to understand the issues that are affecting its present and future viability.

In addition to a philosophical shift in its approach to reporting, there may be some significant education required to align with a new standard. Many companies may use the following tools and strategies to prepare:

1. Forming partnerships and growing relationships with researchers and universities for economic forecasting;
2. Adopting more sophisticated risk assessment tools (both outsourced and proprietary);
3. Assessing internal finance and accounting positions and reviewing staffing requirements;
4. Engaging in proactive dialogue with their auditing firm to discuss and evaluate the proposed standard; and
5. Researching, digesting and deliberating on the current proposed standards and responding with a comment letter to help shape the next draft or ultimate standard.

With comments due by Sept. 24, we will likely see changes and amendments to the proposal going forward. However, this is a significant step toward placing the burden of assessing and reporting going concern issues on management, and also in establishing a more universal criteria and methodology for ultimately evaluating going concern situations and disclosures by auditors.

In shifting management to a more proactive role, FASB hopes to see more accountability and accuracy in all phases of the process. The relationship between management and auditors will remain a cornerstone of the going concern.

Should the proposed standard be approved, however, the interaction between the two entities may take a considerably different direction. It is the investment community's hope that it is a shift in the right direction.

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