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## **The Going-Concern Assumption Revisited: Assessing a Company's Future Viability**

*By Elizabeth K. Venuti*

In 2001, a record 257 publicly traded companies, with a combined \$258.5 billion in assets, filed for bankruptcy, more than doubling the annual average for the previous decade, according to an FDIC publication. While the number of public companies filing for bankruptcy decreased to 191 in 2002, the value of the assets brought into bankruptcy increased to \$368 billion. Twelve of the 20 largest bankruptcy filings in U.S. history took place in 2001 and 2002. In total, these 12 companies brought \$381 billion of assets into bankruptcy (see the [Exhibit](#)).

Given the national recession that officially began in April 2001, the increase in the rate of bankruptcy filings was not completely unexpected. More surprising is the auditors' failure to warn the investing public of the financial distress and impending failure of their clients through modification of the audit report in accordance with SAS 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*. The current crisis in confidence in the audit profession is in part due to auditors' impotence on high-profile engagements such as these.

All 12 companies received an unqualified opinion on their most recent financial statements filed prior to the bankruptcy filing. None of the audit opinions included an explanatory paragraph reflecting the auditor's substantial doubt about the entity's ability to continue as a going concern. A survey of the audit reports for 202 of the 257 publicly traded bankrupt companies that filed for bankruptcy in 2001 revealed that only 96 (48%) of these companies contained a separate paragraph indicating the auditor's doubt about the company's ability to continue as a going concern.

### **The Going-Concern Assumption in Generally Accepted Auditing Standards**

SAS 59 requires an auditor to evaluate conditions or events discovered during the engagement that raise questions about the validity of the going-concern assumption. An auditor who concludes that substantial doubt exists about the entity's ability to continue as a going concern and who is not satisfied that management's plans are enough to mitigate these concerns is required to issue a modified (but unqualified) report. Approximately 40% to 50% of all companies filing for bankruptcy since the effective date of SAS 59 failed to receive a going-concern paragraph in the audit opinion on their last financial statements issued prior to filing for bankruptcy.

An auditor is not required to design specific audit procedures to identify conditions and events that might raise questions about the validity of the going-concern assumption. An auditor should, however, consider whether certain conditions or events discovered during the course of the audit contradict the going-concern assumption. Such information would include the company's ability to

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meet its maturing obligations without selling operating assets, restructuring debt, revising operations based on outside pressures, or similar strategies. A review of prebankruptcy news summaries for the companies indicates that all 12 appeared to be facing such pressures, although the extent to which this was known at the time of the year-end audit cannot be determined. In addition, the auditors would have reviewed management's plans for remediating these conditions.

The recent dearth of going-concern modifications is troubling because of the size of the companies involved as well as the fact that there have been improvements in the auditing standards with respect to an auditor's evaluation and reporting on possible exceptions to the going-concern assumption, improvements that were designed to prevent or reduce the frequency of such audit failures. SAS 34, the auditing standard superceded by SAS 59, was much criticized for its ineffectiveness at warning investors of impending bankruptcies. The "expectations gap" auditing standards, including SAS 59, were issued in response to the widening gap between the levels of expected performance as envisioned by auditors and as perceived by financial statement users. Subsequent to the issuance of SAS 59, there has been only a modest reduction in the frequency of audit failures.

The last great wave of bankruptcies occurred from 1989 to 1991, during the last national recession; most occurred before the effective date of SAS 59. The recent recession and surge in the number of public company bankruptcy filings represents the first true test of the efficacy of SAS 59. According to Thomson Research, during the peak of the 2003 annual reporting season (March 2003), approximately 700 companies received going-concern opinions. This number is about the same as the number of companies receiving going-concern opinions during comparable periods in 2001 and 2000. In other words, despite the weaker economy, there does not appear to be an increase in the number of companies receiving going-concern opinions.

### **Why Auditors Fail to Comment on Exceptions to the Going-Concern Assumption**

Because the issuance of a going-concern opinion is feared to be a self-fulfilling prophecy, auditors may be reluctant to issue one. A going-concern opinion may lower stockholders' and creditors' confidence in the company; ratings agencies may then downgrade the debt, leading to an inability to obtain new capital and an increase in the cost of existing capital. In 1978, the AICPA formed an independent commission (the Cohen Commission) that issued a report expressing this sentiment:

Creditors often regard a subject to qualification as a separate reason for not granting a loan, a reason in addition to the circumstances creating the uncertainty that caused the qualification. This frequently puts the auditor in the position, in effect, of deciding whether a company is able to obtain the funds it needs to continue operating. Thus, the auditor's qualification tends to be a self-fulfilling prophecy. The auditor's expression of uncertainty about the company's ability to continue may contribute to making it a certainty.

The fear is that a going-concern opinion can hasten the demise of an already troubled company, reduce a loan officer's willingness to grant a line of credit to that troubled company, or increase the point spread that would be charged if that company were granted a loan. Auditors are placed at the center of a moral and ethical dilemma: whether to issue a going-concern opinion and risk escalating

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the financial distress of their client, or not issue a going-concern opinion and risk not informing interested parties of the possible failure of the company. The hope is that issuing a going-concern opinion might promote timelier rescue activity.

Another, more troubling reason that auditors might fail to issue a going-concern opinion has been alluded to by the mainstream media in the WorldCom and Enron business failures: lack of auditor independence. Management determines the auditor's tenure and remuneration. The threat of receiving a going-concern modification may send management to another auditor, in a phenomenon referred to as "opinion shopping." Moreover, in an extreme case of a self-fulfilling prophecy, if the client does go bankrupt, the auditor loses future audit fees. This fear of losing future fees could compromise the auditor's ability to render an unbiased opinion on a client's financial statements.

The Private Securities Litigation Reform Act of 1995 made it much more difficult for a plaintiff to bring suit successfully against a company's auditors. While the act did codify as law the reporting requirements of SAS 59, it also made it more difficult for a plaintiff's attorneys to successfully pursue class-action litigation against auditors. Furthermore, in cases where auditors did fail to modify their audit opinions in accordance with SAS 59, the damage awards were limited to proportionate liability. When comparing the potential costs of issuing a going-concern opinion (hastening the demise of the client; losing audit fees) to the costs of not issuing a going-concern opinion (litigation), the result of the act was essentially to tip the scales in favor of not issuing a going-concern opinion. Since the act was passed, high-profile litigation citing the auditors' failure to issue a going-concern opinion, such as the class-action lawsuits by Kmart's shareholders against PricewaterhouseCoopers, and Adelphia's against Deloitte & Touche, has been drastically reduced.

The most critical reason that auditors might fail to issue a going-concern opinion, however, could be a fundamental misunderstanding of the assumption itself.

### **Defining the Going-Concern Assumption and Exceptions**

A difficult problem with making a going-concern assessment is determining what constitutes an exception. Clearly, a company in liquidation ceases to be a going concern. A more fundamental reason that auditors might fail to issue a going-concern opinion, however, may be a fundamental misunderstanding of the assumption itself. Impending liquidation should not be the only exception. The going-concern concept is not clearly defined anywhere in the official pronouncements of either GAAS or GAAP. Because the assumption itself is not defined, there are wide-ranging interpretations of what an exception comprises.

The going-concern assumption is fundamental to accrual accounting. To assume that an entity will continue in business is to say that the entity expects to realize its assets at the recorded amounts and to extinguish its liabilities in the normal course of business. If the going-concern assumption fails, then the amount and classification of assets and liabilities in the balance sheet may need to be adjusted, with consequences to revenues, expenses, and equity. Among other things, the going-concern assumption justifies the current and noncurrent classification within the balance sheet, the allocation of costs over periods benefited, historical cost accounting, and most aspects of the revenue

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recognition and matching principles.

Given the importance of this assumption to GAAP, accountants should find it unsettling that the going-concern assumption is not defined anywhere therein. The only two ancillary references to the going-concern assumption, neither of which provide a definition, are in a footnote on measuring enterprise performance in FASB Concept Statement 1 and in a paragraph on the distinction between current and noncurrent assets in Accounting Research Bulletin (ARB) 43. While the auditing standard does enumerate procedures for the auditor to follow in considering an entity's ability to continue as a going concern, it also fails to define going concern. The statement simply says that "When a company decides or is forced to liquidate, the going-concern concept is not appropriate."

In accordance with Accounting Principles Board (APB) Opinion 22, management is required to describe all significant accounting policies of the reporting entity that were used in preparing their financial statements, including policies on the recognition of revenues and expenses and on the valuation principles applied to various classes of assets and liabilities. Management is not required to perform an evaluation of the entity's ability to continue for the foreseeable future, nor is it required to state that the financial statements were prepared under the assumption that the company will continue in business. Under current GAAP and GAAS, these initial evaluations and the need for disclosure are determined by the auditors, not by management.

### **The Going-Concern Assumption in International Standards**

While the United States still leads the International Accounting Standards Board (IASB) and the International Federation of Accountants (IFAC) in codifying accounting and auditing standards, IASB and IFAC are clearly ahead on the issue of the going-concern assumption. International Accounting Standard (IAS) 1, *Presentation of Financial Statements*, defines the going-concern assumption and requires management to make an assessment of an entity's ability to continue as a going concern. The glossary of terms in the International Standards on Auditing defines the going-concern assumption as follows:

Under the going concern assumption, an entity is ordinarily viewed as continuing in business for the foreseeable future with neither the intention nor the necessity of liquidation, ceasing trading, or seeking protection from creditors pursuant to laws or regulations. Accordingly, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business.

One is left to ponder whether, if similar language had been used in U.S. standards, these 12 companies would have received a going-concern modification in their audit reports.

If possible liquidation is the only time that the going-concern audit opinion is supposed to be used, then SAS 59 is not very useful and falls short of satisfying public expectations. By the time the audit opinion is issued in this situation, the company's financial distress and the bankruptcy filing are already public information. Wouldn't the standard be more useful if it actually called upon auditors to warn the public about the financial distress of their clients, especially because bankruptcy

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proceedings are extremely costly no matter what the outcome? Wouldn't an auditor's job be less ambiguous if management were required to perform an assessment of and comment on the company's ability to continue as a going concern, as articulated in the accounting standards?

If auditors are to rise to meet public expectations, then modifications to the concept statements and auditing standards appear to be necessary.

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