The Auditor's Responsibilities With Respect to Going Concern

An Honors Thesis  (HONRS 499)

by

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One of the most difficult and subjective assessments an auditor must make is the assessment of a company's ability to continue as a going concern. The greatest question, however, is "What are the auditor's responsibilities with respect to going concern?" SAS No. 59 provides some guidance. The auditor's responsibility is to actively consider the entity's going concern status on every audit engagement. The auditor does this by following these steps: evaluating information already obtained from testing other audit objectives, evaluating management's plans to alleviate any negative conditions present, and deciding which opinion to render based on the information found in the previous steps. SAS No. 59 which superseded SAS No. 34 helped clarify the expectations of the auditor with respect to going concern, but it did not provide any objective tests for the auditor to use in his evaluation (Ellingsen et al. 1989, 25). Therefore, the final decision on an entity's going concern status is highly subjective.
OUTLINE

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I. Introduction
   A. What is going concern?
      1. fundamental accounting assumption
      2. presumes that enterprise will continue in
         operation for the foreseeable future
      3. does not imply permanent continuance
   B. Explanation of difficulty in assessing going concern

II. Auditor's responsibilities
   A. Basic responsibility of auditor concerning the financial
      statements
   B. Responsibility of auditor with respect to going concern
   C. Time period auditor is responsible for when assessing
      going concern
   D. Differences between SAS No. 34 and SAS No. 59
      1. Concerning responsibility of audit
      2. Concerning responsibility of period of time

III. Steps in assessing a company's going concern
   A. Evaluate information already obtained
      1. Procedures which usually identify going concern
         problems
         a. analytical
         b. review of subsequent events
         c. review of compliance with terms of debts
         d. reading of minutes of meetings
         e. inquiry of entity's legal counsel concerning
            litigations
         f. confirmation with related and third parties
            of the detail of arrangements to provide
            financial support
      2. Factors considered
         a. negative trends
            (1). recurring operating losses
            (2). working capital deficiencies
            (3). negative cash flows from operations
            (4). adverse financial ratios
         b. other indicators
            (1). default on loan
            (2). arrearage in dividends
            (3). denial of usual trade credit
            (4). debt restructuring
            (5). noncompliance with statutory capital
            requirements
(6). need to sell substantial assets

c. internal matters
   (1). labor difficulties
   (2). loss of key management member
   (3). dependence on success of one product

d. external matters
   (1). legal proceedings that jeopardize ability to operate
   (2). loss of franchise, license, or patent
   (3). loss of key customer or supplier
   (4). uninsured catastrophe

3. Most important factors according to a study in The Practical Accountant
   a. default on loan
   b. recurring losses
   c. denial of credit
   d. negative cash flows
   e. dividends in arrears

B. Evaluate management's plan
   1. Considerations of management's plan
      a. plans to dispose of assets
      b. plans to borrow money or restructure debt
      c. plans to reduce or delay expenditures
      d. plans to increase ownership equity
   2. Evaluate prospective financial information given by management

C. Decide type of opinion to render
   1. Decide if substantial doubt still exists
   2. If substantial doubt does not still exist, issue an unmodified report
   3. If substantial doubt does still exist, consider adequacy of disclosures
      a. if adequate, explanatory paragraph or disclaimer
      b. if not adequate, qualified or adverse opinion
   4. Difference between SAS No. 34 and SAS No. 59
   5. Consider basis of financial statements
      a. regular basis if problems with going concern are not severe
      b. liquidation basis if problems with going concern are severe

IV. Conclusion
The environment of financial accounting and reporting contains four fundamental accounting assumptions (Chasteen et al. 1989, 29). One such assumption is the going concern assumption. The going concern assumption presumes that in the absence of evidence to the contrary, the entity will continue in operation for the foreseeable future (Accountants International Study Group 1975, 1 & 2). Most businesses expect to continue in operation on a relatively permanent basis when they begin operations (Chasteen et al. 1989, 29). An intermediate accounting textbook by Chasteen, Flaherty, and O'Connor gives an excellent analogy of going concern to how people conduct their own lives. Without any reason to expect death in the near future, a person lives as if he has an indefinite, but not infinite, future life (1989, 29). Entities, also realize they will not operate forever, but they do believe they will continue in operation long enough to depreciate assets over their useful lives, pay debts, and meet their contractual commitments (Accountants International Study Group 1975, 3). In other words, entities assume that the carrying value of their assets will be realized and their liabilities will be liquidated in the ordinary course of business (Sullivan et al. 1985, 916).

The going concern assumption is easy to understand, but it is difficult for auditors to assess. Circumstances which affect going concern are easily identified, but the Statements on Auditing Standards provide no operational model with which to evaluate these circumstances. Therefore, the final decision on an entity's going
circumstances. Therefore, the final decision on an entity's going concern is a highly subjective decision made by one or more of the auditing firm's professionals (Koh and Killough 1990, 180-182). A study in Accountant's Magazine reinforces the idea that an entity's going concern status is difficult to assess. The study found that only twenty-one percent of eighty-six companies who failed between 1977 and 1983 were qualified on a going concern basis prior to failure (Taffler and Tseung 1984, 265)

The following hypothetical example will help illustrate the difficult judgements that auditors must make in assessing an entity's going concern. Big Time Consulting Company receives ninety percent of its revenues from one account. If it loses this account and thus ninety percent of its revenues, the company's auditors will likely have doubt as to the company's continued existence (Robison 1989, 57). However, would the company still have going concern problems if it loses an account that provided only eighty percent of its revenues? Or, what if the account only provided seventy percent? Or sixty percent? This is the type of decision which the company's auditors must make. The Statements on Auditing Standards provide no objective levels; and therefore, the decision is based on professional judgement.

Before looking at how the auditor should go about assessing the many factors that could affect going concern, understanding the auditor's basic responsibilities in auditing and his responsibilities with respect to going concern is very important. First of all, when the auditor is engaged to audit a company's
financial statements, his basic responsibility is to express an opinion as to whether those financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows for the company in conformity with generally accepted accounting principles (AICPA 1991, AU 110.02). In order to do this, the auditor must consider going concern.

The Statement on Auditing Standard (SAS) which auditors currently follow with respect to going concern is SAS No. 59 -- The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern. This SAS is in effect for audits of financial statements for periods beginning on or after January 1, 1989, and it superseded SAS No. 34 -- The Auditor's Considerations When a Question Arises About an Entity's Continued Existence. There are four distinct differences between SAS No. 59 and SAS No. 34. Two of these differences will be discussed later in this report. The other two are addressed now. One of these differences concerns the auditor's responsibilities with respect to going concern. The auditor may no longer passively consider an entity's going concern status. He must now actively consider whether a going concern problem exits. Under SAS No. 34, the auditor only had to consider going concern to the extent that audit procedures provided evidence that questioned an entity's continued existence. An entity was assumed to be a going concern without evidence to the contrary. Now, however, SAS No. 59 requires an auditor to review evidence on every audit engagement for indications of an entity's inability to continue as a going concern for a reasonable period of time. This
requirement does not mean, however, that the auditor must perform more procedures than before. If sufficient evidence exists about the entity's status as a going concern after the normal audit procedures, the auditor can make his decision (Robison 1989, 51-52). Additional procedures may be necessary, however, if the auditor feels there could be substantial doubt about an entity's going concern or if he feels he needs more evidence to make a decision (AICPA 1991, AU 341.03).

Another difference between SAS No. 59 and SAS No. 34 concerns the time frame for which the auditor is responsible. SAS No. 34 stated an auditor was responsible for approximately one year. SAS No. 59, however, states that an auditor is responsible "for a period of time not to exceed one year from the date of the financial statements" (AICPA 1991, AU 341.02). This time period is commonly referred to as a reasonable time period. The Accounting Standards Board included this time frame to limit the auditor's responsibilities to existing conditions only. Just as a doctor is not accountable for a patient's future health, the auditor is not expected to predict future events (Ellingsen et al. 1989, 26).

Another hypothetical example will again help illustrate SAS No. 59's meaning. Suppose an auditor issues an unqualified opinion with no explanatory paragraphs on the financial statements of a farm belt bank. A few months later, the bank is forced into receivership because of poor farming conditions. Is the auditor liable in any way (Robison 1989, 57)? Assuming that the auditor conducted his audit in accordance with Generally Accepted
Accounting Principles, he is not liable to the stockholders of the bank. SAS No. 59 stresses that the auditor is not responsible for predicting future conditions or events (AICPA 1991, AU 341.04). He is only responsible for conditions that existed and events that occurred prior to the completion of fieldwork (AICPA 1991, AU 341.02).

In order for the auditor to fulfill his responsibilities—to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time—he should follow the systematic approach provided by SAS No. 59. The first step is to evaluate evidence already obtained. The auditor reviews the information he has obtained by planning, by gathering evidence related to various audit objectives, and by completing the audit. He then considers this information in the aggregate and determines whether there could be substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time (AICPA 1991, AU 341.03)

The information the auditor reviews can come from a variety of procedures. Although there are others, six of those auditing procedures and a few examples of each type will now be discussed. The first task is to apply analytical procedures to the financial statements. The auditor may look at how the company's operating and liquidity ratios compare with industry norms. He may also compare the current year's income statement with previous years' income statements to identify any recurring operating losses. The second type of procedure is a review of subsequent events. There
are many events that can happen after year end that may be of a concern to the auditor. For example, was a scheduled loan payment missed? Has the company suffered an uninsured loss due to a catastrophe? Has the company lost key personnel or customers? The third type of procedure that may provide evidence about an entity's going concern status is a review of compliance with the terms of debt and loan agreements. Whether or not a company has been able to pay its debts on time is of particular importance and reveals much about the entity's ability to do so in the future. Another type of procedure is a reading of stockholder, director, or other committee minutes. This procedure may indicate problems with the company's top management or indicate an intent to sell the company. An inquiry of the entity's legal counsel is another procedure that will help the auditor assess a company's going concern. The auditor would definitely want to know of pending litigations, but he may also want to know the level of insurance coverage the entity has. Finally, a type of procedure that could reveal an entity's going concern problems is a review of related and third party involvement. This procedure would include looking at relations with labor unions, banks, and professional service companies (Robison 1989, 52).

The six procedures above can indicate many conditions and events that may raise a question about an entity's going concern ability. These factors can be divided into four different categories: negative trends, other indicators, internal matters, and external matters.
The first category, negative trends, involves the results of operations of the company. The auditor should look for recurring operating losses, working capital deficiencies, negative cash flows from operations, and adverse financial ratios. The next category, other indicators, is a miscellaneous-type category. It includes such factors as defaults on loans, dividends in arrears, denial of usual trade credit, debt restructuring, noncompliance with statutory capital requirements, and a need to sell substantial assets. The next category, internal matters, deals with those factors that come about from within the company itself. It includes labor difficulties, loss of a key management member, and dependence on success of one product. The final category, external matters, deals with those factors that come about from outside the company. It includes legal proceedings that jeopardize the ability to operate, loss of franchise, license, or patent, loss of key customer or supplier, and an uninsured catastrophe (Miller and Bailey 1988, 8.57). If only one of these factors were present, it would probably not cause the auditor to question an entity's going concern ability; however, when several factors are present, the aggregate effect of these could raise substantial doubt about an entity's ability to continue as a going concern.

With all of these factors, obviously, some are more important than others. In an article in The Practical Accountant, H.J. Williams, a CPA and Assistant Professor of Accounting at Georgetown University, describes a study that involved ranking five of these factors. These factors, in order of ranking, are default on loan
payments, recurring operating losses, denial of usual trade credit, negative cash flows from operations, and arrearages in dividends. According to Williams, these factors are five of the most important conditions that should alert the auditor to going concern problems. The study involved asking national CPA firm partners, regional CPA firm partners, and local CPA firm partners to rank the five issues. Although the three groups did not rank the issues the same, few differences existed. This result shows the importance of these factors and the major impact they could have on the auditor's decision with respect to going concern (1990, 65-66).

After the auditor has evaluated all of the information already obtained through normal audit procedures and if he believes there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, the next step is to "obtain information about management's plans that are intended to mitigate the effect of negative conditions or events, and to assess the likelihood that such plans can be effectively implemented" (AICPA 1991, AU 341.03). Management's plans are usually one or more of the following: to dispose of assets, to borrow money or restructure debt, to reduce or delay expenditures, and/or to increase ownership equity. An important part of this step for the auditor to remember is that management's plans must be considered with professional skepticism. Management's proposals should not be taken at face value, and the auditor should plan and perform audit procedures to obtain evidential matter about them (AICPA 1991, AU
These audit procedures will help the auditor in evaluating the effectiveness of management's plans.

Besides looking at management's plans, the auditor should also look at any prospective financial information given by the client. Of course the client will want to make this information seem as good as possible; so again, the auditor should approach this information with professional skepticism. He should give particular attention to assumptions that are material to the prospective financial information, that are sensitive or susceptible to change, and that are inconsistent with historical trends (AICPA 1991, AU 341.09). Once the auditor has done this, he should compare prior periods' prospective financial information with actual results and the current year's prospective financial information with results achieved to date. If the auditor notices any disparities or any factors not reflected in the financial information, he should discuss these with management and possibly request revision of the information (AICPA 1991, AU 341.09). Accurate and reliable information about what might happen in the future is an important part of the auditor's decision concerning going concern.

After the auditor has evaluated management's plans and prospective financial information, he must make a decision on two separate issues. He must decide whether there is still substantial doubt about the entity's ability to continue as a going concern, and if so, he must decide whether the disclosures in the client's financial statements are adequate to explain this doubt. SAS No.
59 gives some types of information that the disclosures should contain. The disclosures might contain such information as the events and conditions that caused the substantial doubt, the effects of these conditions, management's plans, the recoverability of assets, and the amount of liabilities (AICPA 1991, AU 341.10).

First, if the auditor feels that management's plans have alleviated the substantial doubt as to the company's continued existence, he is not required to modify his report in any way. He should, however, consider both the need for disclosure of the conditions and events which initially caused substantial doubt and the need for disclosure of management's plans to cope with the going concern problems (AICPA 1991, AU 341.11). It is important for the users of this company's financial statements to understand that the auditor's unqualified opinion does not guarantee the company's continued existence since the auditor is not responsible for predicting future events (AICPA 1991, AU 341.04).

Second, the auditor could decide that substantial doubt still exists as to the entity's ability to continue as a going concern. His next step is to then consider the adequacy of the financial statement disclosures. If the auditor feels that the disclosures in the financial statements are not adequate, then a departure from generally accepted accounting principles exists. This means that the auditor is required to issue either a qualified or adverse opinion.

On the other hand, if the auditor decides that the disclosures in the financial statements are adequate, he should include an
explanatory paragraph after the opinion paragraph describing the doubt about the company's continued existence. The paragraph should use the phrase "substantial doubt about its (the entity's) ability to continue as a going concern" (AICPA 1991, AU 341.12). A going concern problem does not cause a qualified opinion. This result is different from what was concluded in the past. Before SAS No. 59, SAS No. 34 required a qualified opinion using the words "subject to" only if the recoverability of asset and liability amounts were in question. Now, however, even if the recoverability of assets and the amounts of liabilities are not in question, SAS No. 59 allows an unqualified opinion with an explanatory paragraph. For example, suppose that a company receives ninety percent of its revenue from one account and loses that account just before year end. The company's only significant asset is the receivable from that account, and it is fully collectible. Under SAS No. 34, the auditor would not change his report in response to the loss of the account because there is no doubt as to the recovery of the company's assets. Now, however, under SAS No. 59, if the loss of the account raises substantial doubt as to the company's ability to continue as a going concern regardless of the status of its assets and liabilities, the auditor would issue an unqualified opinion with an additional explanatory paragraph in the report (Ellingsen et al. 1989, 28).

An important point for the auditor to remember is that SAS No. 59 does not preclude him from issuing a disclaimer if he feels the explanatory paragraph would be inadequate to inform users of the
financial statements of the entity's going concern problems. However, the more common result of a going concern problem is an unqualified opinion with an explanatory paragraph. Following is an example of such an explanatory paragraph.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note X to the financial statements, the Company has suffered recurring losses from operations and has a net capital deficiency that raise substantial doubt about its ability to continue as a going concern. Management's plans in regard to these matters are also described in Note X. The financial statements do not include any adjustments that might result from the outcome of this uncertainty (AICPA 1991, AU 341.13).

The final decision the auditor must make is what basis the financial statements should use. If the entity's going concern problems are not too severe, the financial statements may be presented on the regular basis. If, however, the entity's problems are quite severe, the financial statements should be presented using a liquidation basis. AU 9508.33 --.38 discusses how the auditor reports on financial statements prepared on a liquidation basis of accounting (AICPA 1991).

In conclusion, the auditor's responsibility with respect to going concern is to assess on every audit engagement the entity's ability to continue as a going concern for a reasonable period of time. The steps that the auditor performs--evaluating information already obtained, evaluating management's plans to mitigate the effect of negative conditions, and deciding the type of report to give--enable the auditor to fully assess a company's going concern status. Although this may seem like a simple
process, the decisions the auditor must make throughout the assessment of the entity's going concern can be very difficult. SAS No. 59 clarifies the auditor's requirements, but it does not provide any objective ways to evaluate the entity. The final decision is the auditor's own judgment. This means that one of the most important parts of the going concern issue for users of financial statements to remember is that a report with an unqualified opinion and with no references made to the entity's going concern is not a guarantee of the entity's continued existence. As the auditor has no way to predict or foresee future events, he is only responsible for a reasonable period of time.
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