Introduction

Under federal securities laws and the standards of the Public Company Accounting Oversight Board ("PCAOB" or the "Board"), the auditor has a responsibility to evaluate whether there is substantial doubt about a company's ability to continue as a going concern during the ensuing fiscal year.\textsuperscript{1} In the wake of the recent financial crisis, the PCAOB, as well as certain other standard-setters and regulatory bodies, have been considering the auditor's responsibilities regarding evaluating whether there is substantial doubt about a company's ability to continue as a going concern during the ensuing fiscal year ("going concern evaluation").\textsuperscript{2}

In its assessment of the existing standard regarding the auditor's going concern evaluation, the staff is considering whether the standard should be revised to, among other things:

\textsuperscript{1} See Section 10A(a)(3) of the Securities Exchange Act of 1934 ("Exchange Act"), which requires that each audit include "an evaluation of whether there is substantial doubt about the ability of the issuer to continue as a going concern during the ensuing fiscal year," and paragraph .02 of AU sec. 341, The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern.

\textsuperscript{2} See Appendix A of this briefing paper for examples of the efforts of certain standard-setters and regulatory bodies regarding going concern assessments.
• Provide additional explanation for key concepts underlying the auditor's going concern evaluation;

• Enhance the performance requirements for the auditor; and

• Improve the auditor's reporting of the results of the going concern evaluation.

At the May 17, 2012 meeting of the PCAOB Standing Advisory Group ("SAG"), SAG members will be asked to provide their views on certain possible changes to the Board’s standard governing going concern evaluations relating to the preceding areas. This briefing paper provides background information about each discussion topic and the questions that will be presented during the meeting.3/

Members of the Board's Investor Advisory Group ("IAG") also have discussed the auditor's going concern evaluation.4/ The IAG's Working Group on Going Concern and Related Global Initiatives discussed going concern at the March 28, 2012 IAG meeting.5/ That presentation discussed ways to improve the auditor's performance obligations and reporting of going concern evaluations.

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4/ The IAG discussed the auditor’s going concern evaluation at its March 16, 2011 meeting. See the webcast and the IAG presentation available at http://pcaobus.org/News/Events/Pages/03162011_IAGMeeting.aspx.

5/ See the webcast and the IAG presentation available at http://pcaobus.org/News/Events/Pages/03282012_IAGMeeting.aspx.
The Auditor's Going Concern Evaluation: PCAOB Existing Standard AU sec. 341:

AU sec. 341 establishes requirements for the auditor's going concern evaluation. AU sec. 341.03 states that the auditor should evaluate whether there is a substantial doubt about the company's ability to continue as a going concern for a "reasonable period of time" [not to exceed one year beyond the date of the financial statements being audited], in the following manner:

a. The auditor considers whether the results of the procedures performed in planning, gathering evidential matter relative to the various audit objectives, and completing the audit identify conditions and events that, when considered in the aggregate, indicate there could be substantial doubt about the company's ability to continue as a going concern for a reasonable period of time. It may be necessary to obtain additional information about such conditions and events, as well as the appropriate evidential matter to support information that mitigates the auditor's doubt.

b. If the auditor believes there is substantial doubt about the company's ability to continue as a going concern for a reasonable period of time, the auditor should (1) obtain information about management's plans that are intended to mitigate the effect of such conditions or events, and (2) assess the likelihood that such plans can be effectively implemented.

c. After the auditor has evaluated management's plans, the auditor concludes whether the auditor has substantial doubt about the company's ability to continue as a going concern for a reasonable period of time. If the auditor concludes there is substantial doubt, the auditor should (1) consider the adequacy of disclosure about the company's possible inability to continue as a going concern for a reasonable period of time, and (2) include an explanatory paragraph (following the opinion paragraph) in the financial statements.

6/ In addition to the requirements of AU sec. 341, the auditor may have additional responsibilities, such as, when evaluating compliance with the applicable financial reporting framework. For example, for financial statements prepared under International Financial Reporting Standards ("IFRS"), the auditor also should perform procedures to evaluate whether the financial statements were in conformity with the requirements in the International Accounting Standards Board’s International Accounting Standard 1, Presentation of Financial Statements ("IAS 1"), which are discussed in more detail in footnote 8.
audit report to reflect the auditor's conclusion. If the auditor concludes that substantial doubt does not exist, the auditor should consider the need for disclosure.

AU sec. 341.12 states that if, after considering identified conditions and events and management's plans, the auditor concludes that substantial doubt about the company's ability to continue as a going concern for a reasonable period of time remains, the audit report should include an explanatory paragraph following the opinion paragraph to reflect that conclusion. The auditor's conclusion about the company's ability to continue as a going concern should be expressed through the use of the phrase "substantial doubt about its (the entity's) ability to continue as a going concern." In a going concern explanatory paragraph, the auditor should not use conditional language in expressing a conclusion concerning the existence of substantial doubt about the company's ability to continue as a going concern.

The following is an example of an explanatory paragraph that would follow the opinion paragraph in the auditor's report when the auditor concludes that there is substantial doubt about the company's ability to continue as a going concern for a reasonable period of time:

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.  

Additionally, if the auditor concludes that the company's disclosures with respect to the company's ability to continue as a going concern for a reasonable period of time are inadequate, a departure from generally accepted accounting principles exists, which, if material, requires the auditor to issue either a qualified (except for) or an adverse opinion.

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7/ See AU sec. 341.13.

Key Concepts in the Auditor's Going Concern Evaluation

The PCAOB auditing standards require the auditor to evaluate whether there is substantial doubt about a company's ability to continue as a going concern for a reasonable period of time. Three key concepts are integral to these requirements:

- Substantial doubt;
- Ability to continue as a going concern; and
- Reasonable period of time.

Substantial Doubt

The term "substantial doubt" is not defined in the Financial Accounting Standards Board’s accounting standards or in PCAOB auditing standards. Academic research has shown that there is inconsistent interpretation of the term "substantial doubt." For example, one academic study suggested that "financial statement users may believe that substantial doubt connotes greater assurance of an audit client’s financial demise than intended by auditors." This study found that loan officers and financial analysts assigned a higher probability of failure than did auditors when an audit report contained a going concern explanatory paragraph. The study also noted that defining substantial doubt could reduce problems caused by different interpretations of its meaning.

9/ IAS 1 uses slightly different language. IAS 1 states, "[w]hen management is aware, in making its assessment, of material uncertainties related to events or conditions that may cast significant doubt upon the entity’s ability to continue as a going concern, the entity shall disclose those uncertainties." IAS 1 does not define the terms "material uncertainties," "significant doubt," or "going concern." However, IAS 1 requires companies to "prepare financial statements on a going concern basis unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so."

Similarly, at the April 2, 2009, SAG meeting, some SAG members stated that PCAOB auditing standards should define the term "substantial doubt."11/

Defining the term "substantial doubt" in PCAOB auditing standards could promote greater consistency in the auditor's performance of and reporting on going concern evaluations. It also could help promote a common understanding of the concept among auditors, financial statement preparers, and financial statement users.

One possible approach to defining "substantial doubt" would be to use one of the likelihood thresholds in existing accounting standards. For example, the IAG's Working Group on Going Concern and Related Global Initiatives discussed the idea of the PCAOB using a "more likely than not" threshold for auditor reporting. Other potential thresholds might be "reasonably possible" or "probable," as used in U.S. generally accepted accounting principles.12/

Ability to Continue as a Going Concern

AU sec. 341.01 states that information that significantly contradicts the going concern assumption relates to the company's inability to continue to meet its obligations as they become due without substantial disposition of assets outside the ordinary course of business, restructuring of debt, externally forced revisions of its operations, or similar actions. This statement provides context for understanding when a company might be unable to continue as a going concern pursuant to AU sec. 341.

On its face, the statement in AU sec. 341.01 might initially appear to focus entirely on liquidity because of the language about "inability to continue to meet...obligations as they become due." However, such a view is not consistent with other aspects of the standard. For example, AU sec. 341.06 cites the following as a category of examples of conditions and events that indicate there could be substantial doubt about a company's ability to continue as a going concern:

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12/ The master glossary of the Accounting Standards Codification of the Financial Accounting Standards Board defines "reasonably possible" as "[t]he chance of the future event or events occurring is more than remote but less than likely" and "probable" as "[t]he future event or events are likely to occur."
External matters that have occurred – for example, legal proceedings, legislation, or similar matters that might jeopardize an entity's ability to operate; loss of a key franchise, license, or patent; loss of a principal customer or supplier; uninsured or underinsured catastrophe such as a drought, earthquake, or flood.

To avoid such potential misunderstandings, PCAOB standards could describe in greater detail the concept of the “ability to continue as a going concern,” or alternatively, the “inability to continue as a going concern,” and such description could specifically encompass other factors, in addition to liquidity, relevant to a company's ability to continue in operation.

Reasonable Period of Time

AU sec. 341 limits the auditor's evaluation of whether there is substantial doubt about the company's ability to continue as a going concern to a maximum period of one year beyond the date of the financial statements being audited.\(^{13/}\)

Although such a defined period provides more certainty regarding the auditor's responsibilities, it might limit the usefulness of auditor reporting on its going concern evaluation. For example, if an event affecting the future viability of the company will occur 18 months after the company's year end, incorporating that event into the auditor's going concern evaluation could increase the usefulness of the evaluation and any related auditor reporting on the evaluation.

Also, international accounting standards state that "management takes into account all available information about the future, which is at least, but is not limited to, twelve months from the end of the reporting period."\(^{14/}\) Accordingly, to express an opinion on whether financial statements are presented fairly in conformity with IFRS, the auditor's going concern evaluation needs to cover the same time frame as management's assessment, if that time frame exceeds twelve months.\(^{15/}\)

\(^{13/}\) See AU sec. 341.02.

\(^{14/}\) See IAS 1.

\(^{15/}\) International Auditing and Assurance Standards Board's International Standard on Auditing 570, *Going Concern*, requires the auditor to cover the same period as management's assessment, unless a longer period is required by the accounting framework, law, or regulation.
The usefulness of auditor reporting on its going concern evaluation might be improved if the evaluation period were extended. This might be accomplished by extending the evaluation period for a fixed length of time, such as, to one year from the date of the auditor's report or for an additional year from the date of the financial statements being audited. This type of approach would require a longer evaluation period but the length of that period would be a specified fixed period like the existing one-year evaluation period. A second approach would be to extend the existing one-year evaluation period to include known or likely material events occurring after one year from the date of the financial statements being audited, of which the auditor is aware.\(^\text{16}\) This second approach would require the auditor to take into account important events outside the existing one-year evaluation period without specifying a fixed time frame or establishing a general time frame such as "for the foreseeable future."

Discussion Questions –

1. Should a proposed standard define the term "substantial doubt" using a likelihood threshold such as "reasonably possible," "probable," or "more likely than not"?

2. Should PCAOB auditing standards describe in greater detail the concept of the "ability to continue as a going concern"? If so, how should the concept of going concern be described? For instance, should the description specifically state that it encompasses other considerations in addition to liquidity risks?

3. What time period should an auditor use to evaluate a company's ability to continue as a going concern?

Identifying Conditions and Events That Indicate A Company is Unable to Continue as a Going Concern

Pursuant to PCAOB standards, the auditor's going concern evaluation is based on the auditor's knowledge of relevant conditions and events that exist at or have occurred prior to the date of the auditor's report. Information about such conditions or events is obtained from the application of auditing procedures planned and performed to

\(^{16}\) The second approach was discussed by the IAG's Working Group on Going Concern and Related Global Initiatives.
achieve other audit objectives.\textsuperscript{17} AU sec. 341 indicates that it is not necessary to design audit procedures solely to identify such conditions and events as the results of auditing procedures designed and performed to achieve other audit objectives should be sufficient for that purpose.\textsuperscript{18}

The staff is considering whether to add requirements for the auditor to perform procedures in all audits for the purpose of identifying conditions and events that, individually or in the aggregate, could indicate that there is substantial doubt about the company's ability to continue as a going concern. Examples of specific procedures that might be required include:

\begin{itemize}
  \item[a.] Reading management's going concern assessment or equivalent information regarding management's expectations about future performance and liquidity, such as company forecasts;
  \item[b.] Inquiring of certain management personnel regarding their knowledge of matters that could affect the company's ability to continue as a going concern;
  \item[c.] Reading relevant company filings with the SEC that might identify matters that could affect the company's ability to continue as a going concern (e.g., disclosures in Form 8-K regarding disposition of assets, triggering events that accelerate or increase a direct financial obligation or an obligation under an off-balance sheet arrangement, and material impairments);\textsuperscript{19}
  \item[d.] Assessing the company's liquidity and capital resources and expected future cash flows for the period covered by the going concern evaluation; and
\end{itemize}

\textsuperscript{17} AU sec. 341.02.

\textsuperscript{18} AU sec. 341.05.

\textsuperscript{19} The auditor is already required to read annual reports and quarterly filings, which might discuss such conditions or events (e.g., risk factors, liquidity and capital resources, and results of operations and financial condition). See AU sec. 550, \textit{Other Information in Documents Containing Audited Financial Statements} and AU sec. 722, \textit{Interim Financial Information}.
e. Evaluating whether there are conditions and events that raise doubt about the company's ability to continue as a going concern based on the preceding procedures, relevant information from the risk assessment procedures,\(^\text{20}\) and other audit procedures performed by the auditor.

A proposed standard also could require additional procedures to be performed once the auditor identifies such conditions or events, including procedures to evaluate management's plans for mitigating the adverse effects of those conditions and events.

**Discussion Questions –**

4. Should a proposed standard require the auditor to perform certain procedures for the purpose of identifying conditions and events that could indicate that a company is unable to continue as a going concern? If so, what types of procedures should the auditor perform?

5. Are there other changes to the existing requirements for evaluating the company's ability to continue as a going concern that should be considered?

**Reporting the Results of the Auditor’s Going Concern Evaluation**

Under existing PCAOB standards, if, after considering identified conditions and events and management's plans, the auditor concludes that substantial doubt about the company's ability to continue as a going concern for a reasonable period of time remains, the audit report should include an explanatory paragraph (following the opinion paragraph) to reflect that conclusion.\(^\text{21}\) The auditor's conclusion about the company's ability to continue as a going concern should be expressed through the use of the phrase "substantial doubt about its (the entity's) ability to continue as a going concern,"

\(^\text{20}\) As described in Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, risk assessment procedures include, for example, understanding general economic and industry conditions, understanding sources of the company's funding and earnings; reading public information about the company; observing or reading transcripts of earnings calls; and understanding the company’s objectives, strategies, and related business risks.

\(^\text{21}\) See AU sec. 508 and AU sec. 341.12.
or similar wording that includes the terms "substantial doubt" and "going concern." 22/

When investor advocates or others express concerns about the auditor's reporting in going concern situations, those comments often relate to a perceived lack of timely reporting of going concern uncertainties as opposed to the language used in the auditor's report when substantial doubt exists. 23/ Accordingly, it is conceivable that the potential changes to the standards regarding explanation of key concepts and additional procedural requirements might enhance the usefulness of auditor reporting on going concern considerations without changing the existing reporting requirements.

However, the existing requirements for substantial doubt have limitations that can affect the usefulness of the auditor's reporting on its going concern evaluation. For example, there is no effect on the audit report relating to going concern issues if the auditor concludes that management's plans or other factors mitigate the adverse effects of the conditions and events. 24/ In those situations, investors and other financial statement users would be unaware that the auditor had a heightened concern about the company's ability to continue as a going concern absent the mitigating factors. Also, there is no change to the audit report if the auditor concludes that management's mitigating plans will be effective and those plans involve "substantial disposition of assets outside the ordinary course of business, restructuring of debt, externally forced revisions of its operations, or similar actions," even though such actions would be inconsistent with the going concern concept articulated in AU sec. 341.01 and as discussed previously.

22/ AU sec. 341.12.

23/ See the March 16, 2011 webcast and the IAG presentation available at http:// pcaobus.org/News/Events/Pages/03162011_IAGMeeting.aspx and footnote 6 of Appendix A.

24/ AU sec. 508.41 states that information essential for a fair presentation in conformity with generally accepted accounting principles should be set forth in the financial statements (which include the related notes). When such information is set forth elsewhere in a report to shareholders, or in a prospectus, proxy statement, or other similar report, it should be referred to in the financial statements. If the financial statements, including accompanying notes, fail to disclose information that is required by generally accepted accounting principles, the auditor should express a qualified or adverse opinion because of the departure from those principles.
To address the limitations under the existing reporting requirements and to potentially further enhance the usefulness of auditor reporting on its going concern evaluation, one approach could be to require enhanced reporting, such as an alternative emphasis paragraph in the auditor's report for situations in which there are meaningful going concern uncertainties that do not rise to the level of "substantial doubt." Such a paragraph could describe the conditions and events that raise doubt about the company's ability to continue as a going concern and management's mitigation plans or other mitigating factors external to the company. In addition, such a paragraph could state the conditions and events that led the auditor to believe there could be substantial doubt and the auditor's conclusion that substantial doubt has been alleviated.

The following is an example of such an emphasis paragraph that describes conditions, events, and management's plans:

As disclosed in Note X to the financial statements, the Company lost its largest customer in Division A of the business, and, consequently, management plans to merge Division A into Division B and implement strategies to reduce costs in the merged division.

The following is an example of a paragraph that includes the auditor's conclusion that substantial doubt has been alleviated:

As disclosed in Note X to the financial statements, the Company lost its largest customer in Division A of the business, which led us to believe that there could be substantial doubt about the company's ability to continue as a going concern. However, management’s plans to merge Division A into Division B and implement strategies to reduce costs in the merged division have alleviated such substantial doubt.

Such an emphasis paragraph could be required based on different criteria from those for the explanatory paragraph required by AU sec. 341. For example, an emphasis paragraph could be required in one or more of the following situations (or based upon other specified conditions):

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25/ If such matters are already disclosed in the financial statements, the paragraph could reference the details in the financial statement disclosure rather than repeating them in the auditor's report.
a. When it is reasonably possible that the company would be unable to continue as a going concern;

b. When the auditor's doubt about the company's ability to continue as a going concern is mitigated by management's plans or external factors;

c. When management's plans to mitigate substantial doubt involve "substantial disposition of assets outside the ordinary course of business, restructuring of debt, externally forced revisions of its operations, or similar actions."

Discussion Questions –

6. Should audit reports include enhanced reporting, such as an emphasis of matter paragraph, to alert financial statement users about going concern uncertainties that do not rise to the level of substantial doubt? If so, what form should that enhanced reporting take, when should that enhanced reporting occur (e.g., reasonably possible, more likely than not, or another threshold), and what should be the extent of the enhanced reporting?

7. Are there other changes to the auditor's report regarding the going concern evaluation that should be considered?

8. Would including in an emphasis of matter paragraph a statement that substantial doubt is alleviated potentially be perceived as an auditor providing an opinion or other form of assurance about the company's ability to continue as a going concern?

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The PCAOB is a nonprofit corporation established by Congress to oversee the audits of public companies in order to protect investors and the public interest by promoting informative, accurate, and independent audit reports. The PCAOB also oversees the audits of broker-dealers, including compliance reports filed pursuant to federal securities laws, to promote investor protection.
Appendix A

Overview of Certain Efforts of Other Standard-Setting Organizations and Regulatory Bodies

In addition to the PCAOB, other standard-setters and regulatory bodies also have considered ways to improve the going concern assessments performed by management, directors, or auditors. This appendix discusses examples of the activities of other standard-setters and regulatory bodies.

The FASB has projects on its agenda on disclosures about risks and uncertainties and the liquidation basis of accounting and on liquidity and interest rate risk disclosures.


2/ A summary of the FASB project on disclosures about risks and uncertainties and the liquidation basis of accounting is available at http://www.fasb.org/cs/ContentServer?site=FASB&c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FProjectUpdatePage&cid=900000011115.

3/ See the liquidity and interest rate risk project update at http://www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FProjectUpdatePage&cid=1175801889654.
In November 2011, the European Commission issued a proposal that would, among other things, require the statutory audit report to "provide a statement on the situation of the audited entity or, in case of the statutory audit of consolidated financial statements, of the parent undertaking and the group, especially an assessment of the entity's or the parent undertaking's and group's ability to meet its/their obligation in the foreseeable future and therefore continue as a going concern."\textsuperscript{4/}

The UK Financial Reporting Council ("FRC") commissioned the Sharman Inquiry to "identify lessons for companies and auditors addressing going concern and liquidity risks."\textsuperscript{5/} In November 2011, the Sharman Inquiry issued its Preliminary Report and Recommendations of the Panel of Inquiry.\textsuperscript{6/} The report recommended, among other things, that:

- the FRC harmonize and clarify the purpose of the going concern assessment and disclosure process in the guidance for directors and auditors,
- the FRC ensure that the going concern guidance for directors reflects the right focus on solvency risks, not only on liquidity risks (including identifying risks to the company’s business model or capital adequacy), and


\textsuperscript{5/} See http://www.frc.org.uk/about/sharmaninquiry.cfm. The lack of going concern modifications for banks that subsequently failed has been a source of concern for U.K. regulatory agencies and lawmakers. See, e.g., http://www.parliament.uk/business/committees/committees-a-z/lords-select/economic-affairs-committee/inquiries/auditors-market-concentration-and-their-role/.

• the auditor’s report include a statement as to whether the auditor is satisfied that, having considered the directors’ going concern assessment process, they have nothing to add to the disclosures made by the directors about the robustness of the process and its outcome.

The IAASB issued a revised International Standard on Auditing No. 570, *Going Concern* ("ISA 570") in July 2008.\(^7\) The IAASB recently added a project to its agenda to enhance the communicative value of the auditor’s report regarding the company’s ability to continue as a going concern. The Auditing Standards Board of the AICPA is currently considering revisions to its existing standard on going concern and issued an exposure draft for comment November 11, 2011.

\(^7\) ISA 570 is effective for audits of financial statements for periods beginning on or after December 15, 2009.