Disclosing Uncertainties in a Going Concern

01.21.15

In August 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-15, Disclosure of Uncertainties About an Entity's Ability to Continue as a Going Concern. The ASU provides guidance on management's responsibility to evaluate whether there's substantial doubt about a company's ability to continue as a going concern and to provide related footnote disclosures.

No Existing Guidance

Under Generally Accepted Accounting Principles (GAAP), financial statements are prepared under the presumption that a company will continue as a going concern unless and until liquidation becomes imminent. If that happens, it should switch from the going concern basis of accounting to the liquidation basis of accounting.

What if liquidation isn't imminent, but conditions or events raise substantial doubt about a company's ability to continue as a going concern? Should management disclose this information in the financial statements? Previously, GAAP provided no answers to these questions. The ASU provides guidance on this issue by incorporating and expanding on certain principles found in U.S. auditing standards.

Making The Evaluation

Under the ASU, for each annual and interim reporting period, management should evaluate whether conditions or events, considered in the aggregate, raise substantial doubt about the company's ability to continue as a going concern within one year after the financial statements are issued or are available to be issued.

Substantial doubt exists if, based on relevant conditions and events that are "known or reasonably knowable" on the date the financial statements are issued or available to be issued, it's probable that the company will be unable to meet its obligations as they become due within one year. The ASU offers examples of conditions and events that may raise substantial doubt, including:

- Negative financial trends, such as recurring losses or negative cash flows,
- Other signs of financial difficulty, such as defaults on loans, arrearages in dividends, denial of usual trade credit or the need to restructure debt to avoid default,
- Internal matters, such as work stoppages or other labor difficulties, substantial dependence on a particular project's success, or "uneconomic" long-term commitments, and
- External matters, such as adverse legal proceedings or legislation; loss of a key franchise, license, or patent; loss of a principal customer or supplier; or an underinsured catastrophe.

If substantial doubt exists, management should consider whether its plans to mitigate relevant conditions or events alleviate that doubt. Is it probable that these plans will be implemented effectively? If so, is it probable that they'll mitigate the conditions or events that raise substantial doubt about the company's going concern status?

According to the ASU, these plans might include ways to dispose of an asset or business, borrow money or restructure debt, or increase ownership equity.

Disclosing Substantial Doubt

If conditions or events raise substantial doubt about a company's ability to continue as a going concern, but management's plans alleviate that doubt, the financial statement footnotes should disclose: 1) the principal conditions or events that raised substantial doubt, 2) management's evaluation of their significance in relation to the company's ability to meet its obligations, and 3) management's plans that alleviated substantial doubt.

If plans fail to alleviate doubt, the company should state in the footnotes that there's substantial doubt about the company's ability to continue as a going concern within one year after the financial statements are issued or available to be issued. The footnotes also should disclose information about the principal conditions or events that raised substantial doubt, management's evaluation of their significance, and management's mitigation plans.

Be Prepared

The ASU is effective for the annual period ending after Dec. 15, 2016, and for annual and interim periods thereafter. Earlier application is permitted. To prepare for the new evaluation and disclosure requirements, management should develop policies and procedures for evaluating the company's going concern status during each interim and annual period and determining whether financial statement disclosures are required.

The ASU contains a flowchart that outlines the decision process. It's on page 12 of Update No. 2014-15; the link can be found at http://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1176156316498.