



The Going-Concern Assumption: Its Journey into GAAP

By William Hahn

The going-concern assumption is universally understood and accepted by accounting professionals. Indeed, the assumption of a going concern is critical to the decision usefulness of financial information under the accrual basis of accounting. It is also the justification for valuing most assets at historical cost. It has, however, received little attention in the accounting literature and has never been formally incorporated into U.S. GAAP.

Even though users understand that management is responsible for the form and content of a business's financial statements, there is no official guidance requiring management to assess their

entity's ability to continue as a going concern. Currently, AU section 341 provides the only formal guidance in this area. This section states, in part, that "the auditor has a responsibility to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time." If there is substantial doubt, an explanatory paragraph should be included in the auditors' report.

This responsibility often places an auditor in an uncomfortable position with clients. Research conducted by Audit Analytics reveals that, over a 10-year period (2000–2009), an average of 18.5% of

all audit opinion letters included a going-concern modification. This is about 2,950 modifications each year for SEC filers.

Auditors are about to get relief. Sometime during the first quarter of 2011, FASB intends to issue a Statement of Financial Accounting Standards, *Going Concern*. When adopted, this standard will leave no doubt as to who is charged with making the going-concern determination. Such responsibility will be clearly placed on management. But the going-concern assumption's journey into GAAP did not start with FASB. It started in the 17th century, as chronicled below.

Short History of the Going-Concern Assumption

As shown in *Exhibit 1*, the first documented use of the term "going concern" was traced by economist John R. Commons to a 1620 lawsuit in which the value of assets was in dispute. In this lawsuit, the court distinguished between a going-concern value and a value tantamount to the current concept of historical cost.

Following the 1620 case, the going-concern idea remained mainly in the legal domain (primarily related to entity value determination) until 1892, when Lawrence R. Dicksee published *Auditing: A Practical Manual for Auditors*. As reported by R.K. Storey, Dicksee argued that assets should be valued on a going-concern basis and not adjusted for "a fluctuation in value caused by external circumstances." Clearly, Dicksee viewed the going-concern idea as a basis for accounting for assets using historical costs.

While the literature is incomplete on how the going-concern idea was presented and debated after Dicksee's book formalized the discussion in 1892, Storey reports that the next major step was Henry Rand Hatfield's 1909 book, *Modern Accounting: Its Principles and Some of Its Problems*, which included the going-concern assumption. In a 1927 book, *Accounting: Its Principles and Problems*, Hatfield expanded his discussion of the going-concern assumption, indicating that the concept was generally accepted among practicing accountants of that era.

Remember, there was no formal standards-setting body at the time Dicksee and Hatfield were writing about the going-concern assumption. While groups that were

precursors of the AICPA existed between 1887 and 1939, the first formal group to promulgate accounting principles was the Committee on Accounting Procedure (CAP), which was a subgroup of the American Institute of Accountants (the forerunner of today's AICPA). The CAP issued 51 Accounting Research Bulletins (ARB) between 1939 and 1959.

The first introduction of the going-concern assumption into the formal accounting literature occurred in 1953, when the CAP issued ARB 43, *Restatement and Revision*

In 1978, FASB issued Statement of Financial Accounting Concepts (SFAC) 1, *Objectives of Financial Reporting by Business Enterprises*. Paragraph 42 of this statement states the following:

Financial reporting should provide information about an enterprise's financial performance during a period. Investors and creditors often use information about the past to help in assessing the prospects of an enterprise. Thus, although investment and credit decisions reflect investors' and creditors' expectations about future enter-

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of Accounting Research Bulletins. In chapter 3, section A, "Current Assets and Current Liabilities," of that bulletin, the CAP asserted: "It should be emphasized that financial statements of a going concern are prepared on the assumption that the company will continue in business." This assertion established the importance of continuity as a basis for the decision usefulness of financial statements.

In 1961, the AICPA issued Accounting Research Study 1, *The Basic Postulates of Accounting*. In this document, crafted by Maurice Moonitz, postulate C-1 states the following:

Continuity (including the correlative concept of limited life). In the absence of evidence to the contrary, the entity should be viewed as remaining in operation indefinitely. In the presence of evidence that the entity has a limited life, it should not be viewed as remaining in operation indefinitely.

The continuity postulate was listed along with objectivity, consistency, stable measuring unit, and disclosure as essential to effective accounting and financial reporting.

prise performance, those expectations are commonly based at least partly on evaluations of past enterprise performance.¹⁰

It is only in footnote 10 of SFAC 1 that the going-concern assumption is mentioned. Footnote 10 states, in part, the following:

Investors and creditors ordinarily invest in or lend to enterprises that they expect to continue in operation—an expectation that is familiar to accountants as "the going concern" assumption.

In 1989, the AICPA issued Statement on Auditing Standards (SAS) 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (later incorporated in AU section 341), which, as previously discussed, placed the burden of a going concern determination on the auditor. Paragraph .02 states the following:

The auditor has a responsibility to evaluate whether there is substantial doubt about the entity'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 (hereinafter referred to as a *reasonable period of time*).

EXHIBIT 1
Chronology of the Going-Concern Assumption

Date	Event
1620	Economist John R. Commons traced the going-concern concept to a 1620 lawsuit (<i>Jollife v. Brode</i> , Cro. Jac. 596) in which a court determined that a going-concern value was greater than the book value (historical cost minus depreciation) of the plant because the plant could be used to generate excess income through future operations. This appeared in his 1924 book <i>Legal Foundations of Capitalism</i> . ¹ C.T. Devine points out that a continuing entity (going concern) is clearly different from one subject to liquidation.
1892	Lawrence R. Dicksee's book <i>Auditing: A Practical Manual for Auditors</i> is published and is the first to provide a description and rationale for the going-concern assumption. ²
1909	Henry Rand Hatfield publishes <i>Modern Accounting: Its Principles and Some of Its Problems</i> , which includes a discussion of the going-concern assumption. ²
1927	Henry Rand Hatfield publishes <i>Accounting: Its Principles and Problems</i> , in which he identifies a going concern as being generally accepted. ²
1953	The American Institute of Accountants publishes Accounting Research Bulletin 43, <i>Restatement and Revision of Accounting Research Bulletins</i> , which includes the going-concern assumption in chapter 3, section A, "Current Assets and Current Liabilities."
1961	The AICPA issues Accounting Research Study 1, <i>The Basic Postulates of Accounting</i> , in which the going-concern idea is incorporated in postulate C-1, Continuity.
1978	FASB issues Statement of Financial Accounting Concepts 1, <i>Objectives of Financial Reporting by Business Enterprises</i> , in which the going-concern assumption is incorporated via footnote 10.
1989	The AICPA issues SAS 59, <i>The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern</i> , which charges auditors with evaluating whether an entity is indeed a going concern.
2008	The AICPA issues its <i>Omnibus Statement on Standards for Accounting and Review Services 17</i> , which requires public accountants to evaluate the ability of an entity to continue as a going concern when contemplating the issuance of a compilation or review report.
2008	FASB issues a proposed Statement of Financial Accounting Standards, <i>Going Concern</i> .
2011	FASB projects finalizing the exposure draft on going concern in the first quarter of 2011.

1. From C. T. Devine, *Studies in Accounting Research #22*, vols. III and IV, American Accounting Association, 1985.

2. As recounted in R. K. Storey, "Revenue Realization, Going Concern and Measurement of Income," *Accounting Review*, vol. 34, no. 2, pp. 232-238, 1959.

As the international standards convergence movement gathered momentum, the AICPA and FASB moved to formalize the going-concern assumption into published guidance. The AICPA included a going-concern requirement in its 2008 *Omnibus Statement on Standards for Accounting and Review Services (SSARS) 17*. This section, in paragraph 69, added the following language:

During the performance of compilation or review procedures, evidence or information may come to the accountant's attention indicating that there may be an uncertainty about the entity'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 compiled or reviewed (hereinafter referred to as a *reasonable period of time*). In those circumstances, the accountant should request that management consider the possible effects of the going concern uncertainty on the financial statements, including the need for related disclosure.

Finally, in 2008 FASB issued its proposed SFAS, *Going Concern*, discussed below.

Proposed Going-Concern Standard

The proposed statement on going concern has been in exposure draft form since October 9, 2008, and the impetus for its issuance is the convergence with international standards. As shown in *Exhibit 2*, the language set forth in the exposure draft is almost identical to that of sections 25 and 26 of International Accounting Standard (IAS) 1, *Presentation of Financial Statements*. There are only two areas of difference between the standards. First, there are a few phrasing differences which are simply a matter of writing style; these are highlighted in *Exhibit 2*. Second, the guidance is presented in two paragraphs in the international standard, whereas it is in four paragraphs (three, four, seven, and eight) in the proposed standard.

As *Exhibit 2* shows, paragraph three of the proposed guidance clearly establishes responsibility in this area. Paragraph three states, in part, that "management shall assess the reporting entity's ability to continue as a going concern." Paragraph four suggests a minimum 12-month forward time horizon over which management should evaluate "current and expected profitability, debt repayment schedules, and potential sources

of replacement financing” as aspects of a comprehensive going concern assessment.

If, after such assessment, management concludes that there is substantial doubt as to the organization’s ability to continue as a going concern, it must disclose that conclusion. In addition, the proposed standard

requires that management set forth the reasons why such a determination was made, as well as the basis upon which the current-year financial statements are presented.

In a going-concern assessment, paragraph five of the exposure draft sets forth examples of events that, either individual-

ly or in concert with each other, could lead management to conclude that substantial doubt exists as to the ability of an organization to continue as a going concern. Examples provided by FASB are negative performance trends in the areas of profitability or cash flow, as well as sig-

EXHIBIT 2
Comparing IAS 1 to FASB’s Proposed Standard

International Accounting Standard 1, <i>Presentation of Financial Statements</i>, Issued September 1997	FASB Exposure Draft, “Going Concern,” Issued October 9, 2008
<p>25. When preparing financial statements, management shall make an assessment of an entity’s ability to continue as a going concern. An entity shall 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.</p> <p>When 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. When an entity does not prepare financial statements on a going concern basis, it shall disclose that fact, together with the basis on which it prepared the financial statements and the reason why the entity is not regarded as a going concern.</p>	<p>3. When preparing financial statements, management shall assess the reporting entity’s ability to continue as a going concern. An entity shall prepare financial statements on a going concern basis unless management either intends to liquidate the entity or to cease operations or has no realistic alternative but to do so.</p> <p>7. When management is aware, in making its assessment, of material uncertainties about events or conditions that may cast substantial doubt upon the entity’s ability to continue as a going concern, the entity shall disclose those uncertainties. [Note: list of examples not presented.]</p> <p>8. When an entity does not prepare financial statements on a going concern basis, it shall disclose that fact, together with the basis on which it prepared the financial statements and the reason why the entity is not regarded as a going concern.</p>
<p>26. In assessing whether the going concern assumption is appropriate, 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. The degree of consideration depends on the facts in each case. When an entity has a history of profitable operations and ready access to financial resources, the entity may reach a conclusion that the going concern basis of accounting is appropriate without detailed analysis. In other cases, management may need to consider a wide range of factors relating to current and expected profitability, debt repayment schedules and potential sources of replacement financing before it can satisfy itself that the going concern basis is appropriate.</p>	<p>4. In assessing whether the going concern assumption is appropriate, management shall take into account all available information about the future, which is at least, but is not limited to, 12 months from the end of the reporting period. The degree of consideration depends on the facts in each case. If an entity has a history of profitable operations and ready access to financial resources, management may conclude that the going concern basis of accounting is appropriate without detailed analysis. In other cases, management may need to consider a wide range of factors relating to current and expected profitability, debt repayment schedules, and potential sources of replacement financing before it can satisfy itself that the going concern basis is appropriate.</p>

Critics argued that the time horizon is too long and too nebulous, that it will be difficult for practitioners to apply, that the language conflicts with time frames set forth in GAAS, and that the proposed time frame could have legal ramifications.

nificant events such as a regulatory order, loan default, or creditor unwillingness to engage in business. In addition, internal operational problems and “external matters such as legal proceedings, legislation, loss of a key business franchise, license, or patent, customer, or environmental occurrence” may contribute to management’s determination. If such a determination is

made, paragraph six provides specific information management should consider in deciding how to deal with the conditions and events that inhibit going-concern capacity as well as the likelihood that such plans can be implemented successfully.

Should management conclude that substantial doubt exists as to the ability of an organization to continue as a going con-

cern, paragraph seven of the proposed standard requires the disclosure of the basis for such an assessment and any course of action that management plans to pursue in order to attempt to return the organization to going concern status. Proposed disclosures are shown in *Exhibit 3*.

Comments on the Exposure Draft

Those responding to the exposure draft generally agreed with FASB’s proposed move to include a going-concern assessment in GAAP. Nevertheless, concerns were expressed in four areas: the types of information required as part of management’s assessment, the time horizon over which such an assessment must be made, specific disclosure requirements, and the definition of a going concern.

Types of information required. The first area of concern revolves around a change in wording from AU section 341 to the proposed standard. In paragraph .02 of AU section 341, an auditor is required to consider “knowledge or relevant conditions and events that exist at or have occurred prior to the date of the auditor’s report,” whereas the proposed standard (paragraph four) requires management to consider “all available information about the future.”

Commenters argued that the “all available information” wording was too broad and implied that management would need to assess unlimited amounts of information into an unforeseeable future. Others contended that the cost of conducting a going concern assessment of the scope required by the exposure draft would be too high with respect to the benefits realized from such an assessment. Finally, some thought that the wording would result in inconsistent application in practice.

FASB decided to modify paragraph four of the proposed standard by removing the word “all.” As revised, this aspect of the standard will read “management shall take into account available information.”

Time horizon. The time horizon set forth in the exposure draft drew the most attention from commenters. Critics argued that the time horizon is too long and too nebulous, that it will be difficult for practitioners to apply, that the language conflicts with time frames set forth in GAAS, and that the proposed time frame could have legal ramifications. The areas of greatest concern were the workability of the open-

EXHIBIT 3 Going-Concern Disclosures

Paragraph 7. The following disclosures are required when management, applying commercially reasonable business judgment, is aware of conditions and events that indicate, based on current facts and circumstances, that it is reasonably foreseeable that an entity may not be able to meet its obligations as they become due without substantial disposition of assets outside the ordinary course of business, restructuring of debt, issuance of equity, externally or internally forced revisions of its operations, or similar actions.

- a. Pertinent conditions and events giving rise to the assessment, including when such conditions and events are anticipated to occur, if reasonably estimable
- b. The possible effects of those conditions and events
- c. Possible discontinuance of operations
- d. Management’s evaluation of the significance of those conditions and events and any mitigating factors
- e. Management’s plans to mitigate the effects of the conditions and events, whether those plans can be effectively implemented, and the likelihood that such plans will mitigate the adverse effects.
- f. Information about the recoverability or classification of recorded asset amounts or the amounts or classification of liabilities.

Note: The above is the language FASB used in setting forth its alternative to a specific going-concern definition requested by respondents to the exposure draft. This was approved at its March 31, 2010, meeting.

ended time frame in the U.S. legal environment and an apparent conflict with currently existing auditing guidance that uses a one-year time frame (e.g., SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*; SFAS 6, *Classification of Short-Term Obligations Expected to Be Refinanced*; and AU section 341).

FASB decided to modify the time frame so that events beyond one year in the future must be compelling if they are to be considered in the going-concern assessment. In their rationale for this change in language, FASB indicated that the definition is not intended to be open-ended or indefinite. To clarify this intent, the first two sentences of paragraph four (shown in Exhibit 2) will be changed to read as follows. In assessing whether the going-concern assumption is appropriate—

management shall take into account available information about the foreseeable future, which is generally, but not limited to, 12 months from the end of the reporting period. Certain events that are expected to occur or are reasonably foreseeable beyond 12 months, and would materially affect the assessment, are considered part of the foreseeable future. The time frame beyond 12 months is limited to a practical amount of time thereafter in which significant events or conditions that may affect the evaluation can be identified.

Thus, 12 months was set as the workable time frame, but FASB's modification allows for professional judgment in extending the time frame beyond 12 months, based on known facts and circumstances.

Disclosure requirements. A third area of concern is related to the disclosure of going-concern circumstances. Commenters pointed out that there is inconsistency between the proposed disclosures and those in IAS 1, as well as the omission of certain disclosures currently set forth in AU section 341, paragraph 11. Respondents also noted that it was unclear as to whether disclosures were required in each year's annual report only if there is doubt as to an organization's ability to continue as a going concern. Finally, it was suggested that the proposed language be changed to explicitly state that management had made a determination as to going-concern status.

At its January 13, 2010, meeting, FASB considered the use of the term "substantial doubt" as it appears in paragraph seven of the exposure draft (see Exhibit 3). Based on the comments received, the board concluded that the language should be modified. The two possibilities under consideration are: "it is more than

the final going-concern standard. Such changes will clarify the concepts and requirements but will not change either the substance or intent of the proposal.

Journey's End

When issued, the going-concern guidance will appear in the Accounting

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remote that the entity will not continue as a going concern," and "it is more likely than not that the entity may not continue as a going concern."

At this time, specific language has not been adopted by FASB, but it will be, prior to the issuance of the final standard in 2011. Upon consideration of the two possibilities, option two seems more likely to be incorporated into the standard's final language. This is because option one's phrasing is difficult and because option two's wording is similar to that used in other standards (e.g., SFAS 109) which makes it the more likely candidate for inclusion in the final standard.

FASB also made some minor changes to the wording and order of presentation of the required disclosures. The modified disclosures are set forth in Exhibit 3.

Going concern definition. Finally, the proposed standard does not contain a definition of a going concern. Commenters suggested that FASB include a definition in order to provide the clarity that would remove judgment and uncertainty in this area.

Nevertheless, FASB has decided not to provide a going-concern definition. Instead, a going concern will be determined by means of the disclosures discussed in the previous section and through application of the revised disclosure instructions as set forth in Exhibit 3.

As noted above, the comments on the exposure draft will result in changes to

Standards Codification (ASC) section 205, "Presentation of Financial Statements." For example, section 205-30-45-1, "Other Presentation Matters," is proposed to read, in part—

When preparing financial statements, management shall assess the reporting entity's ability to continue as a going concern. An entity shall prepare financial statements on a going concern basis unless management either intends to liquidate the entity or to cease operations or has no realistic alternative but to do so.

Notice that the codification wording is identical to that of the exposure draft, and that this codification section will include all of the guidance set forth in paragraphs three through eight of the going-concern standard once it is adopted by FASB.

In conclusion, when FASB finalizes the going-concern standard in 2011, management will be required to perform an assessment of an entity's ability to continue as a going concern. Auditors, while still having a responsibility to ascertain going-concern status under AU section 341, will be in a position to evaluate management's determination—but not originate the going-concern assessment, as is now the practice. □

William Hahn, DBA, CPA (inactive), is a professor of accounting at Southeastern University, Lakeland, Fla.