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ACCOUNTANTS & ADVISORS

ACCOUNTING AND AUDITING ALERT: NEW ACCOUNTING STANDARD TACKLES DISCLOSURES ABOUT BUSINESS CONTINUITY

The Financial Accounting Standards Board (FASB) has updated U.S. Generally Accepted Accounting Principles (GAAP) to eliminate a critical gap in existing standards. The new guidance, found in Accounting Standards Update (ASU) 2014-15, *Presentation of Financial Statements — Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern*, clarifies the disclosures management must make in the organization's financial statement footnotes when management has substantial doubt about its ability to continue as a "going concern." The guidance applies to all companies.

The gap in GAAP

Except in limited circumstances, financial statements that comply with GAAP are prepared under the presumption that the organization will continue to operate as a going concern — what's commonly known as the going-concern basis of accounting. If and when an organization's liquidation becomes imminent, financial statements are prepared under the liquidation basis of accounting.

An organization, however, might face certain adverse conditions or events that raise substantial doubt about its ability to continue before it's clear that liquidation is imminent, during which period financial statements must still be prepared on the going-concern basis. Until now, GAAP provided no guidance on management's responsibility to evaluate or disclose such conditions. Although footnote disclosures regarding these conditions have commonly been provided, different organizations have had different views about when substantial doubt exists. This has led to variations in whether, when and how organizations disclose the relevant conditions and events.

Other prevailing standards

U.S. auditing standards and federal securities law require auditors — not management — to evaluate whether there's substantial doubt about an organization'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. U.S. auditing standards further require auditors to consider the possible financial statement effects, including footnote disclosures on uncertainties about an organization's ability to continue for a reasonable period of time.

The U.S. Securities and Exchange Commission has also provided guidance on the disclosures it expects from an organization when an auditor's report includes an explanatory paragraph that reflects substantial doubt about the organization's ability to continue for a reasonable period of time.

International Financial Reporting Standards (IFRS) require disclosures when management is aware of material uncertainties related to events and conditions that may cast significant doubt on the organization's ability to continue as a going concern. Under IFRS, the assessment period is at least one year from the financial statement date (e.g., December 31 2015 for a December 31, 2014 balance sheet), with no upper time limit.

Under International Standards on Auditing (ISA), of interest only to some of our clients in certain circumstances in which they have to issue financial statements to foreign entities, the auditor has an assessment period that is the greater of 1) the period for which management makes such an assessment, 2) the minimum period specified by the reporting framework (e.g., GAAP) used in preparing the financial statement, or 3) one year from the financial statement date.

Evaluating "substantial doubt"

FASB issued ASU 2014-15 in response to stakeholders' concerns about the lack of guidance in GAAP on what qualifies as substantial doubt. In the guidance, it opted to incorporate and expand on certain principles currently in U.S. auditing standards. The disclosures required under the new guidance, therefore, may not substantially alter the information disclosed in many audited financial statements. Nonetheless, FASB found it beneficial to define management's responsibility under GAAP to evaluate when and how substantial doubt about the organization's ability to continue as a going concern should be disclosed in the financial statement footnotes.

The ASU's definition of "substantial doubt" amounts to a high threshold. It calls for a focus on significant uncertainties about an organization's ability to continue, rather than requiring a broader consideration of all uncertainties and risk factors.

Under the new standard, an organization's management must evaluate whether conditions or events raise substantial doubt about the organization's ability to continue as a going concern for a period of one year from the date the financial statements are issued or, when applicable, available to be issued. The one-year limit diverges from IFRS. It also diverges from existing U.S. auditing standards for which the one-year period begins on the date of the financial statements.

For example, under U.S. auditing standards, the assessment period for a December 31, 2016 balance sheet that is available to be issued on April 30, 2017, would extend through December 31, 2017, while under the new GAAP guidance it would be through April 30, 2018. The U.S. auditing standards do not yet specifically address what the auditor's report would include in this example if there was no substantial doubt about the ability of the entity to continue as a going concern trough December 31, 2017 but there were substantial doubt about its continuing through April 30, 2018. The expectation is that the U.S. auditing standards will be amended so that the assessment period will follow whatever management is using, which would be one year from the issuance (or available to be issued) date if the financial statements are being prepared under GAAP.

Even if U.S. auditing standards are not changed, it would be difficult to justify the auditor's report not having an emphasis of a matter pointing a financial statement assessment of substantial doubt.

Substantial doubt exists when conditions or events, considered in the aggregate, indicate that it's probable (meaning likely to occur) that the organization will be unable to meet its obligations as they become due within one year. The term "probable" as used in GAAP has generally been understood to mean at least 70% to 75% chance. Under U.S. auditing standards substantial doubt has not been clearly defined, although studies have shown that auditors have generally used a threshold between 50% to 70%. Putting aside the extension of the period of time for the assessment, the implementation of ASU 2014-15 may result in substantial doubt being assessed to exist less frequently than under U.S. auditing standards.

Management's evaluation should consider both qualitative and quantitative information about relevant conditions and events. This information includes the organization's current financial condition, conditional and unconditional obligations due or anticipated within one year, and the funds necessary to maintain operations.

Disclosure requirements

When management identifies conditions or events that raise substantial doubt, it must consider whether its plans for mitigating those conditions or events will be effective. The mitigating effect of the plans should be considered only to the extent that 1) it's probable that the plans will be effectively implemented, and, if so, 2) it's probable that the plans will mitigate the conditions or events that raise substantial doubt about the organization's ability to continue as a going concern.

If the plans alleviate the substantial doubt, the organization must make footnote disclosures that allow users of the financial statements to understand:

- Principal conditions or events that raise substantial doubt, before consideration of management's plans,
- Management's evaluation of the significance of those conditions or events in relation to the organization's ability to meet its obligations, and
- Management's plans that alleviated substantial doubt.

If, however, management's plans don't alleviate the substantial doubt, the organization must indicate in the footnotes that substantial doubt exists about the organization's ability to continue.

Management also must disclose information that allows users to understand:

- Principal conditions or events that raise substantial doubt,

- Management's evaluation of the significance of those conditions or events in relation to the organization's ability to meet its obligations, and
- Management's plans that are intended to mitigate the conditions or events that raise substantial doubt.

If conditions or events continue to raise substantial doubt in subsequent reporting periods, the organization should continue to make the required going-concern disclosures in those periods. Disclosures should become more extensive as additional information becomes available about relevant conditions or events and management's plans.

Effective date

The changes in ASU 2014-15 will take effect for the annual financial statement period ending after Dec. 15, 2016, and for annual periods and interim periods thereafter. Early application is permitted. If you have questions about how the new guidance may affect the preparation of your company's financial statement, please give us a call.

FOR MORE INFORMATION

If you have questions regarding this guidance, please contact:

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