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Financial Accounting Standards Board 401 Merritt 7  
P.O. Box 5116  
Norwalk, Connecticut 06856-5116

**File Reference No. 2013-300, Presentation of Financial Statements (Topic 205):  
Disclosure of Uncertainties about an Entity's Going Concern Presumption**

Dear Technical Director:

The Center for Audit Quality (CAQ) is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets. The CAQ fosters high quality performance by public company auditors, convenes and collaborates with other stakeholders to advance the discussion of critical issues requiring action and intervention, and advocates policies and standards that promote public company auditors' objectivity, effectiveness, and responsiveness to dynamic market conditions. Based in Washington, D.C., the CAQ is affiliated with the American Institute of Certified Public Accountants (AICPA).

The CAQ appreciates the opportunity to respond to the Financial Accounting Standards Board's (FASB or the Board) Proposed Accounting Standards Update, *Presentation of Financial Statements (Topic 205): Disclosure of Uncertainties about an Entity's Going Concern Presumption* (the Proposed ASU). Comments expressed in this letter are primarily focused on the effects of the Proposed ASU on public companies. This letter represents the observations of the CAQ, but not necessarily the views of any specific firm, individual, or CAQ Governing Board member.

The CAQ commends FASB for its efforts in developing a going concern model that requires preparers to perform a going concern assessment and, where required, to provide footnote disclosures about going concern uncertainties each reporting period. Under current U.S. auditing standards, auditors are required to assess whether there is substantial doubt about an entity's ability to continue as a going concern.<sup>1</sup> However, the preparer's responsibilities related to its assessment and disclosures of conditions and events (and any related plans) that may give rise to substantial doubt are not explicitly defined within U.S. Generally Accepted Accounting Principles (US GAAP).

We believe the Proposed ASU represents an improvement over the current going concern model that relies on existing general requirements related to the preparer's disclosure of material information, as well as the auditor's binary substantial doubt determination under applicable auditing standards. The Proposed ASU makes explicit

<sup>1</sup> Paragraph 3, AU Section 341, The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern (AU 341).

that the responsibility for the going concern assessment and related disclosures rests within the financial statement preparation process; and provides for more timely information about challenges facing the preparer and the preparer's plans to address them. It also would help provide users of the financial statements with more clarity on the nature of conditions and events that may raise substantial doubt about the preparer's ability to realize its assets and meet its obligations in the ordinary course of business. However, we believe there are several areas requiring significant attention by the Board to make the Proposed ASU operational in practice. These include: (1) a lack of sufficient application guidance surrounding the evaluation of management's plans, both within, and outside the ordinary course of business, and the evidence needed to assess the likelihood of success of such plans, and (2) a need for further clarification around the substantial doubt threshold.

We also continue to have concerns about the proposed use of a more likely than not disclosure threshold and the fact that no disclosure would be required in circumstances where an entity concludes there is an exact 50% probability, rather than a 50.01% chance, that the entity will be unable to meet its obligations within 12 months after the financial statement date without taking actions outside the ordinary course of business. We continue to believe that the use of a 'reasonably likely' threshold is a more appropriate starting point for such disclosures. This approach embodies a range concept for the disclosure trigger, and should help drive earlier disclosure of certain conditions and events, which is an area that has been stressed by a number of financial statement user groups. In the event the Board continues to embrace the more likely than not concept, we believe that further application guidance will be necessary to assist financial statement preparers and auditors with the 'close call' situations.

## **OTHER STANDARD-SETTER AND REGULATORY EFFORTS ON GOING CONCERN**

The Proposed ASU is one of a number of global initiatives by standard-setters and regulators aimed at taking a fresh look at going concern assessment and reporting. The International Auditing and Assurance Standards Board (IAASB) issued an *exposure draft*<sup>2</sup> on possible changes to the auditor's reporting model, which includes consideration of additional communications in the auditor's report related to going concern matters. The Financial Reporting Council (FRC) is considering a similar project to revise the accounting and auditing guidance related to going concern, based on feedback it received on its Consultation Paper, *Implementing the Recommendations of the Sharman Panel – Revised Guidance on Going Concern and revised International Standards on Auditing (UK and Ireland)*.<sup>3</sup> Further, the Public Company Accounting Oversight Board (PCAOB) has a project on its agenda to review the standards that define the auditor's responsibilities in this area.

The CAQ believes that improvements in the going concern reporting model will most effectively be achieved by accounting and auditing standard-setters continuing to work together to develop complementary standards; and we encourage standard-setters to consider the benefits to users of the financial statements of aligning the key concepts in the various proposals.

## **OUR VIEWS ON THE BENEFITS OF THE PROPOSED ASU**

The CAQ recognizes that if adopted, the Proposed ASU would result in a number of significant changes in practice for both management and the auditor. We believe these changes are necessary and would result in improved financial statement disclosures related to significant risks and uncertainties impacting an entity's ability to continue as a going concern. This would provide users of the financial statements with a clearer understanding of matters that affect the preparer's assessment, by better linking various disclosures related to liquidity or other uncertainties to the going concern evaluation. It would also help provide relevant information about conditions and events at an earlier stage than under the current auditor-driven model.

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<sup>2</sup> IAASB Exposure Draft, Reporting on Audited Financial Statements: Proposed New and Revised International Standards on Auditing ([link](#)).

<sup>3</sup> FRC Consultation Paper, Implementing the Recommendations of the Sharman Panel: Revised Guidance on Going Concern and revised International Standards on Auditing (UK and Ireland) ([link](#)).



The following outlines our views on what we believe to be the most significant shortcomings of existing practice and how the Proposed ASU will help address many of these concerns:

#### *Lack of Explicit Financial Statement Preparer Requirements for Going Concern Matters*

International Accounting Standard 1, *Presentation of Financial Statements* (IAS 1) requires the preparer to assess an entity's ability to continue as a going concern and prepare the financial statements on a going concern basis unless the preparer either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so.<sup>4</sup> In addition, IAS 1 requires the preparer to disclose material uncertainties related to events or conditions that are identified, if they cast significant doubt upon the entity's ability to continue as a going concern.<sup>5</sup> By contrast, US GAAP does not explicitly require management to make a similar assessment.

The Proposed ASU makes explicit what was before implied in US GAAP — that the responsibility for the going concern assessment and related disclosures rests within the financial statement preparation process. It also defines the preparer's responsibilities, which are presently implied by U.S. auditing standards.

#### *Certain Key Concepts Are Not Defined*

Key terms such as 'going concern' and 'substantial doubt' are not presently defined in the accounting or auditing standards, or further described in implementation guidance. A lack of clarity with respect to these terms has contributed to diversity in practice in the interpretation and application of these terms. Defining these terms will help promote consistency in understanding and application by preparers, auditors, and users of the financial statements.

#### *Finite Measurement Period*

U.S. auditing standards currently limit the going concern evaluation to a maximum period of one year beyond the date of the financial statements being audited.<sup>6</sup> This time horizon provides certainty about the auditor's responsibilities, but may limit the usefulness of the reporting if the conditions and events are anticipated to occur just beyond the 12-month period. For example, assume that a significant portion of the preparer's debt is due approximately 15 months after the preparer's year-end and refinancing this debt could represent a significant challenge to the preparer's ability to continue as a going concern. Under current standards, this uncertainty would not be required to be explicitly disclosed by the preparer, nor incorporated into the auditor's going concern assessment.

The CAQ agrees with the expansion of the evaluation period beyond 12 months, and the limitation of that assessment to conditions and events that meet a probable threshold beyond the 12-month period. We believe expanding the assessment period addresses the present problem that a bright-line 12-month time horizon poses relative to conditions and events anticipated to occur just beyond the one-year time frame. Moreover, limiting the assessment of conditions and events beyond 12 months to those that meet the probable threshold provides for the consideration of only the most significant known conditions and events facing the entity.

The CAQ also agrees with the requirement to perform the going concern assessment at the end of each reporting period, rather than the current annual auditor-driven assessment. This approach is consistent with the overall objective of providing specific information to users of the financial statements about challenges to an entity's ability to continue as a going concern earlier than under current practice.

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<sup>4</sup> Paragraph 25, IAS 1.

<sup>5</sup> Ibid.

<sup>6</sup> Paragraph 2, AU 341.

### *Limitations of a Binary Decision Framework*

An auditor's decision as to whether to modify the audit report is currently a binary decision. At present, the auditor decides whether to include an explanatory paragraph based on his or her assessment as to whether conditions and events raise substantial doubt about the preparer's ability to continue as a going concern within 12 months of the financial statement date, after considering the preparer's plans to address such matters.

Since there is no explicit requirement in current US GAAP for preparers to disclose matters bearing on the entity's ability to continue as a going concern, financial statement disclosures are often tied to the auditor's conclusion. In situations where the auditor has concluded that an explanatory paragraph is required due to the existence of substantial doubt, the auditor's consideration of the adequacy of the preparer's disclosures, as outlined in AU 341 (for audits of public issuers),<sup>7</sup> and AU-C Section 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AU-C 570) (for audits of non-public entities),<sup>8</sup> ultimately provides a primary source of guidance for preparers' disclosures. In situations where concerns over substantial doubt are ultimately alleviated, auditing standards require the auditor to consider whether the preparer should disclose the principal conditions and events that initially caused the concern, as well as any mitigating factors.<sup>9</sup> However, auditing standards do not provide preparers a framework for this consideration and with no similar requirements explicit in US GAAP, judgments regarding the necessity for disclosures may not always be consistently applied.

The CAQ believes a scalable disclosure model, whereby preparers' disclosures become more extensive as additional information becomes available,<sup>10</sup> would be an improvement to the existing approach and help provide more timely disclosures.

### *The Self-Fulfilling Prophecy*

Many have asserted that under the present model, an auditor's report containing a 'going concern' explanatory paragraph could become a 'self-fulfilling prophecy' and could increase the likelihood that the preparer will fail. In the CAQ's view, the amendments within the Proposed ASU help alleviate some of the self-fulfilling prophecy concerns by requiring earlier disclosure of challenges to an entity's ability to continue as a going concern, before those concerns reach the threshold where there is substantial doubt.

## **MANAGEMENT'S OBJECTIVITY**

The Proposed ASU seeks feedback regarding management's ability to objectively assess and provide disclosure of uncertainties about the entity's ability to continue as a going concern.<sup>11</sup> Management's potential bias is inherent in making many subjective decisions required in the preparation of financial statements. We do not believe the evaluation of matters that could impact an entity's ability to realize its assets or meet its obligations in the ordinary course of business is inherently different from certain other significant assessments requiring substantial judgment, such as the evaluation of possible impairments, accruals for litigation and other contingencies, or the determination of the fair value of illiquid or harder to value financial instruments. We recognize that many of these going concern judgments will be challenging and fully understand the ramifications of certain conclusions, particularly in circumstances where it is determined that substantial doubt may exist, can be severe. We believe this to be true for issuers as well as non-issuers. Management is able to overcome inherent bias in making numerous other financial statement assertions involving judgment; therefore, they should also be able to do so when evaluating whether there is substantial doubt. However, the going concern assessment *must* be an explicit part of the financial statement

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<sup>7</sup> Paragraph 10, AU 341.

<sup>8</sup> Paragraph 12, AU-C 570.

<sup>9</sup> Paragraph 11, AU 341 (applicable to public issuers) and paragraph 13, AU-C 570 (applicable to non-public entities).

<sup>10</sup> Paragraph 205-40-50-8, Proposed ASU.

<sup>11</sup> Questions for Respondents #4, the Proposed ASU.



preparation process. The potential for management bias is not a reason to exclude management from the process of reaching a conclusion in this area. However, as more fully explained below, we do believe preparers and auditors would benefit from additional guidance regarding the factors to be considered in determining whether an entity meets a particular disclosure threshold.

## **POSSIBLE DISCLOSURE OVERLAP**

Securities and Exchange Commission (SEC) requirements for management discussion and analysis (MD&A)<sup>12</sup> provide disclosure guidance aimed at assisting financial statement users in determining, among other things, whether there is a trend or uncertainty that is reasonably likely to have a material effect on the entity's financial condition or results of operations. The CAQ acknowledges that the Proposed ASU may include some aspects of financial reporting that could overlap with certain SEC MD&A disclosure requirements (including those related to risk factors and liquidity). However, we believe such information is fundamental to the preparation and presentation of the financial statements, and therefore, should be included as part of the financial statement footnotes. In addition, when contrasted to the SEC's MD&A disclosure requirements, we believe the disclosures in the Proposed ASU have a narrower, more specific, focus on going concern uncertainties. We anticipate that the Proposed ASU disclosures would be limited to pertinent information about significant conditions and events that are specific to going concern uncertainties. SEC filers may use MD&A to complement and expand upon financial statement disclosures by providing additional context about the potential causes and effects of these uncertainties. Furthermore, the Proposed ASU disclosures, and related internal controls and processes around the evaluation of going concern uncertainties by the preparer, would be subject to auditing procedures including, in many cases, consideration of the preparer's internal controls in this area.

Stakeholders have also suggested that current reporting could be enhanced to help them understand, on a more complete basis, the most significant risks facing the entity.<sup>13</sup> For example, during the CAQ's Workshop on the Evolving Role of the Auditor, stakeholders commented that, "*risk factor disclosures tend to be focused on strict compliance with the requirements rather than providing meaningful discussion of the most significant factors that make an investment speculative or risky.*"

While we recognize that there may be concerns about disclosure of forward-looking information in order to comply with the Proposed ASU,<sup>14</sup> such information is often used in other areas of financial reporting such as impairment evaluations and deferred tax asset valuation allowances. For instance, a preparer's goodwill impairment testing often includes assumptions about future business performance, typically in the form of cash flow projections, which are utilized to assess the recoverability of recorded assets.

## **SPECIFIC OBSERVATIONS ON THE PROPOSED ASU**

We believe the observations described below will enhance the Proposed ASU and have organized these observations and comments as follows:

- Proposed Definitions
- Identifying Conditions and Events that Should be Evaluated for Disclosure
- Threshold Determination
- Evaluation of Management's Plans Within and/or Outside the Ordinary Course of Business
- Disclosures
- Other Matters

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<sup>12</sup> Release No. 303-8056 regarding Item 303 of Regulation S-K, Management's Discussion and Analysis of Financial Condition and Results of Operations.

<sup>13</sup> Page 7, Summary of Workshop on the Evolving Role of the Auditor, the Center for Audit Quality ([link](#)).

<sup>14</sup> Questions for Respondents #8, the Proposed ASU.



## PROPOSED DEFINITIONS

The CAQ supports FASB's intention to define the various terms (i.e., going concern and substantial doubt) within the Proposed ASU. However, in order to ultimately provide for consistent interpretation and application, we believe these proposed definitions and terms should be further clarified and suggest enhancements in the following areas:

### *Going Concern Presumption*

The going concern presumption appears to be inconsistently applied and not aligned with other concepts within the Proposed ASU. The going concern presumption definition notes that the 'inherent presumption' in going concern is that the entity will be able to realize assets and meet obligations in the ordinary course of business.<sup>15</sup> However, paragraph 205-40-05-2 of the Proposed ASU states the going concern presumption is required to be used unless liquidation is imminent, while paragraph 205-40-50-3 states that disclosure considerations should start when an entity is unable to meet its obligations. The Proposed ASU outlines circumstances and related required disclosures that will detail significant challenges to the entity's ability to realize assets and meet obligations, and many of these events and circumstances could occur well before 'liquidation is imminent.' To illustrate, assume a situation where an entity has chosen to file for bankruptcy under Chapter 11 of the Bankruptcy Code in an attempt to 'reorganize' its business. Although management is no longer able to meet its obligations, liquidation is not 'imminent.' The entity continues to operate under the going concern presumption and management would be required under the Proposed ASU to consider disclosure of the conditions and events. Therefore, we believe it will be helpful to better align (or bridge) these concepts.

A suggested approach in this regard could be a revised going concern presumption definition that aligns better with the liquidation subtopic 205-30<sup>16</sup> and may read as follows:

*"The inherent presumption in preparing financial statements under U.S. generally accepted accounting principles is that an entity will be able to continue as a going concern; that is, the entity will continue to operate such that it will be able to realize its assets and meet its obligations in the ordinary course of business. Notwithstanding, an entity might face circumstances that raise questions as to whether it will be able to continue to operate in this manner, which will require it to make disclosure of these circumstances pursuant to this ASU, the entity's financial statements should be prepared under the going concern presumption unless liquidation is imminent, in accordance with Subtopic 205-30, Liquidation Basis of Accounting."*

### *Substantial Doubt*

The CAQ supports linking the definition of substantial doubt to the term 'probable,'<sup>17</sup> as this concept is defined within US GAAP and would promote consistent application of the standards and, combined with the expanded disclosure requirements for preparers, provide for more useful information for users of the financial statements. However, the CAQ is unclear as to the basis for FASB's assertion in Paragraph BC36 that states, "*this definition most closely approximates the upper end of the range in the present interpretation of substantial doubt.*" We encourage FASB to either provide its basis for this statement, or not include the statement in the final ASU or accompanying background material.

We are also concerned that the inclusion of the word 'known' in the 'known or probable' threshold for evaluation of substantial doubt may result in varied interpretation. In particular, the phrase '*known or probable that an entity will be unable to meet its obligations as they become due,*' could be interpreted that in order for a preparer to reach a

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<sup>15</sup> Paragraph 3, Going Concern Presumption, the Proposed ASU.

<sup>16</sup> Subtopic 205-30, Liquidation Basis of Accounting.

<sup>17</sup> ASC 450-20-20, Glossary, Loss Contingencies.



substantial doubt conclusion, a condition or event must arise that results in an entity being on the verge of bankruptcy or liquidation, as the term ‘known’ is viewed by some to mean ‘certain.’ The CAQ does not support this interpretation of ‘known’ as ‘certain’ as this would significantly limit the preparer’s substantial doubt conclusions, which we do not believe is consistent with the objective of the Proposed ASU. Therefore, we encourage FASB to revise its substantial doubt definition as follows:

- **Known or Probable** – Replace the phrase ‘known or probable,’ with ‘probable’ as ‘known’ is subsumed within the term ‘probable.’
- **Severe Impact** – Incorporate the term ‘severe impact,’ by revising the phrase ‘unable to meet its obligations’ to ‘having a severe impact on the preparer’s ability to meet its obligations.’ As defined in Accounting Standards Codification (ASC) No. 275, Risks and Uncertainties, (ASC 275),<sup>18</sup> ‘severe impact’ focuses on conditions and events that would affect the ‘normal functioning of the entity,’ and excludes from consideration conditions and events that do not have a severe effect on the preparer’s normal, day-to-day operations. This would allow for more consistent application of the Proposed ASU by not limiting the preparer’s assessment to high thresholds that could influence the preparer’s substantial doubt conclusions.

A revised substantial doubt definition could be:

*“Substantial doubt exists when the preparer concludes that a known condition or event is probable of having a severe impact on the preparer’s ability to realize its assets and meet its obligations in the ordinary course of business.”*

## **IDENTIFYING CONDITIONS AND EVENTS THAT SHOULD BE EVALUATED FOR DISCLOSURE**

The Proposed ASU notes that the disclosure assessment should be based on conditions and events that exist at the date the financial statements are issued.<sup>19</sup> The CAQ, however, is concerned that without further clarification, hindsight could be unfairly used to assert that any and all adverse conditions and events becoming transparent within 24 months following the date the financial statements are issued, even those the preparer could not reasonably be expected to know or foresee, should have been incorporated into the preparer’s financial statement date going concern disclosure evaluation. We believe it should be made very clear that the going concern assessment is not intended to incorporate future matters that cannot reasonably be expected to be known to the preparer at the time the financial statements are issued. Specific language should be built into the proposal, and perhaps be supplemented with some examples illustrating the concepts. For example, a sharp and significant decline in broader economic conditions in later 2013 that has a severe adverse effect on the preparer’s operations in that period is an illustration of a condition or event that was likely not known at the time the 2012 financial statements were prepared. Likewise, a product recall in 2013 of products shipped in 2012 that has an adverse effect on the preparer’s operations in 2013, also illustrates a condition or event, assuming the recall is initiated based on facts coming to light in 2013 that were not known at the time the 2012 financial statements were issued.

On the other hand, an entity’s estimate of operating losses for the 2013 period, available at the time the 2012 period-end financial statements are issued, is an illustration of an existing condition for purposes of the 2012 financial statement preparation process, notwithstanding the losses are expected to be incurred in the future.

In consideration of the CAQ’s observations noted above, paragraph 205-40-50-2 could be revised to read:

*“In assessing an entity’s ability to meet its obligations, management shall consider all available information about conditions and events that are reasonably expected to be known at the date the financial statements are issued (or for a nonpublic entity the date that the financial statements are available to be issued).”*

<sup>18</sup> ASC 275-10-20 Glossary.

<sup>19</sup> Paragraph 205-40-50-2, the Proposed ASU.

The CAQ believes that incorporating the proposed revision to paragraph 205-40-50-2 into the discussion of existing conditions and events will provide appropriate protection to financial statement preparers and clarify for all parties the scope of past, present and future conditions and events to be included in a preparer's going concern assessment.

The CAQ further believes that the examples outlined in paragraph 205-40-55-3 should be modified to clarify that management's assessment includes matters that have occurred or are reasonably expected to occur for which information is available at the time the financial statements are prepared. For instance, paragraph 205-40-55-3(d), outlines certain external matters that 'have occurred' (past tense) and identifies examples of the loss of a key franchise, license or patent. We believe the language is confusing as to whether the preparer's assessment should include such events if they had not actually occurred as of the financial statement date, but information is available whereby the preparer reasonably expects them to occur (and the events may have a severe impact on the entity's business) within the following 12 or 24-month period.

## **THRESHOLD DETERMINATION**

### *Meeting the Disclosure Threshold*

The CAQ believes that preparers would benefit from additional guidance regarding the types of evidence (subjective versus objective) needed to support the conclusion on whether a particular disclosure threshold has (or has not) been met. Without additional guidance, preparers may have difficulties in consistently reaching the disclosure threshold conclusions.

To illustrate, assume a situation where an entity has material debt coming due in 22 months. Under these circumstances, would a formal financing commitment have to be in place for the preparer to conclude it has met (or has not met) the more likely than not or probable threshold? If not, what other indication of interest or commitment would be necessary? Further, how should the preparer consider its past financing experiences (e.g., the preparer has in the past successfully refinanced similar debt arrangements on a number of occasions), the status of its relationships with its financial lending institutions and the current status of the lending market in concluding whether the appropriate threshold has been met? Alternatively, how should the preparer consider the effectiveness of its plans when it has limited previous experience refinancing its obligations (despite it potentially being a common occurrence in the marketplace)?

The Proposed ASU is also not clear how a plan's overall feasibility, including the preparer's ability (or inability) to influence the contemplated action steps, may affect the preparer's ultimate disclosure threshold determinations. This is not simply an issue for auditors, but a matter needed to be reflected in the standard to provide preparers with a better, and more specific, understanding of expectations in this area. At present, paragraph 205-40-50-9 notes that, "*an entity shall consider the effect of all of management's plans that are likely to be effectively implemented and likely to mitigate the adverse conditions and events, including those outside the ordinary course of business.*"<sup>20</sup> We believe this brief articulation does not appropriately outline what it might take to meet these important requirements. Building off the previous illustration, how does the likelihood that the preparer can (or cannot) confirm financing for the material debt that is due in 22 months impact the preparer's threshold determinations? Such an analysis would appear to be integral to the determination of whether disclosures are needed, as well as (for public issuers) whether substantial doubt may exist.

Moreover, regardless of whether plans are considered within or outside the ordinary course of business, we believe it would be helpful to provide additional guidance on the level of management control over the significant elements of the plan necessary to evaluate that its plan likely will be successful. This is particularly important in assessing whether there is substantial doubt.

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<sup>20</sup> Similar language is included in paragraph 204-40-50-4(f) of the Proposed ASU.



Given the uncertainty related to the ability of a preparer to effectively implement its plans, we also believe the Proposed ASU should more clearly articulate how any alternative plans that the preparer may develop should be considered in its analysis. For example, we believe that as the degree of uncertainty with respect to the likely success of the preparer's plans increases, more persuasive evidence would be needed with respect to the ability to successfully execute management's plans and the potential effect of the alternative plans to mitigate the impact of the conditions and events.

#### *More Likely Than Not*

When evaluating potential disclosure thresholds, we understand that care must be taken in striking a balance between (1) providing earlier disclosures of significant conditions and events and (2) requiring disclosure of conditions and events that have too low a likelihood of having a severe impact on an entity's ability to meet its obligations. We believe striking such a balance avoids disclosure overload, which might de-sensitize financial statement users to such disclosures.

The CAQ appreciates FASB's position regarding the use of a more likely than not threshold (e.g., aligns with the Board's objective; threshold is well understood and applied in other areas of US GAAP). However, we have a number of concerns regarding its operational limitations, particularly in close-call situations. Under US GAAP, more likely than not is considered to be a likelihood of more than 50%. We believe this probability threshold may be too high to capture significant early stage liquidity issues. In addition, the CAQ believes that precise evaluation of probability required by the more likely than not threshold (i.e., greater than 50% probability) is difficult to make operational in practice. This benchmark, in our view, will also tend to signal that such assessments can be made with a high degree of specificity, which we doubt is the case. We also have significant concerns that no disclosure would be required in circumstances where an entity concludes (assuming this is even practically possible) there is an exact 50% probability, rather than a 50.01% chance, that the entity will be unable to meet its obligations within 12 months after the financial statement date without taking actions outside the ordinary course of business. We continue to believe that the use of 'reasonably likely' is a more appropriate disclosure starting point than more likely than not, as it represents a range that may be more applicable in close-call situations, and more conducive to providing earlier disclosures. Moreover, reasonably likely strikes an appropriate balance by providing: (1) more timely disclosure, (2) a sufficiently high floor for considering conditions and events that result in disclosure of truly significant matters, and (3) a threshold that is familiar in practice, particularly for public issuers. SEC guidance, for example, has interpreted 'reasonably likely' as a lower threshold than more likely than not, but a higher threshold than remote, when used in the context of MD&A disclosures.<sup>21</sup>

#### *Substantial Doubt Determination*

In evaluating and determining whether there is substantial doubt, paragraph 205-40-50-9 of the Proposed ASU states that a preparer should, "consider the effect of all of management's plans that are **likely** to be effectively implemented and **likely** to mitigate the adverse conditions and events, including those outside the ordinary course of business."<sup>22</sup> However, the Proposed ASU lacks sufficient guidance regarding how to assess whether it is likely a plan will be successful and the level of documentation necessary to support such an assessment. The CAQ believes preparers and auditors would benefit from FASB clarifying, through application guidance, its interpretation of the term 'likely,' including clarifying the probability threshold that is necessary when evaluating management's plans that are 'likely' to be effectively implemented and mitigate the adverse condition and event.

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<sup>21</sup> Paragraph 9220.11, Topic 9, Management's Discussion and Analysis of Financial Position and Results of Operations (MD&A), Division of Corporation Finance's Financial Reporting Manual.

<sup>22</sup> Similar language is included in paragraph 204-40-50-4(f) of the Proposed ASU.

*Considering the Impact of the Likelihood of ‘Successful Plan Execution’*

When determining whether the disclosure thresholds described in paragraph 205-40-50-3 have been met, and whether there is substantial doubt, it is important to understand the gross risk attributable to the underlying conditions and events that create uncertainty about an entity’s going concern presumption (i.e., gross risk) and the net risk remaining after considering the impact of management’s plans (i.e., net risk).

The CAQ would suggest including the following chart as a supplement to paragraphs 205-40-55-1 and 205-40-55-2 in the Proposed ASU to illustrate this concept. Although we have expressed concerns throughout this letter regarding the use of the more likely than not threshold, the thresholds for disclosure as defined in the ASU have been employed here for convenience.

<b>Gross Risk (Before Consideration of Management’s Plans)</b>	<b>Likelihood of Success of Management’s Plans<sup>23</sup></b>	<b>Net Risk (After Consideration of Management’s Plans)</b>	<b>Resulting Disclosure Threshold<sup>24</sup></b>
Probable	Less than likely	Probable	Substantial doubt
	Likely	More likely than not	More likely than not
	Probable	Less than more likely than not	No disclosure
More Likely than Not	Less than likely	More likely than not	More likely than not
	Likely	Less than more likely than not	No disclosure
	Probable	Less than more likely than not	No disclosure

When evaluating the likelihood of success of management’s plans, this guidance should emphasize that in order for management’s plan to likely be effective, the significant elements of the plan should be under sufficient management control. For example, management may plan to increase revenues, to increase cash flows and address a specific gross risk. To increase revenue, management may have significantly expanded its sales force in key markets. While expanding the sales force is under management’s control, increasing revenue also requires unrelated third parties to enter into sales transactions. Such third parties are typically not under management’s control. This may result in the conclusion that it is less than likely management’s plans will be successful in addressing the gross risk facing the entity.

This additional guidance to management would also improve the auditor’s ability to arrive at more consistent conclusions regarding whether the disclosure thresholds have been met and whether there is substantial doubt, considering the types and level of audit evidence available to be obtained.

**EVALUATION OF MANAGEMENT’S PLANS WITHIN AND/OR OUTSIDE THE ORDINARY COURSE OF BUSINESS**

The CAQ recognizes that a preparer faces a myriad of conditions and events that, viewed in isolation, could have an impact on the preparer’s ability to meet its obligations as they become due in the ordinary course of business. We

<sup>23</sup> Considerations in determining the likelihood of success of management’s plans would include the nature of the plans, frequency of actions, and magnitude of the plans. In evaluating if the entity has met the disclosure threshold as defined in the Proposed ASU, the mitigating effect of plans outside the ordinary course of business would not be considered (Paragraph 205-40-50-5).

<sup>24</sup> The mitigating effect of plans outside the course of business would be considered in determining whether there is substantial doubt (Paragraph 205-40-50-9).

believe further guidance is needed to assist preparers in determining whether an entity meets (or does not meet) the more likely than not or probable threshold, as well as whether the actions it intends to take are within or outside the ordinary course of business.

*Ordinary Course of Business*

We appreciate that the Proposed ASU includes examples illustrating the factors to consider in the determination of whether management’s plans are within or outside the ordinary course of business (paragraphs 205-40-55-4 through 205-40-55-9). However, we believe the Proposed ASU does not go far enough in illustrating a number of important factors that should be considered in making this determination including: the nature of the plans, the frequency with which actions have historically occurred, or the potential magnitude of the impact of the plans on the entity and its financial statements.

The CAQ believes that the interplay between the likelihood of conditions and events and whether actions taken by management are within or outside the ordinary course of business requires the use of judgment and that further implementation guidance in the form of additional examples similar to those in paragraphs 205-40-55-4 through 205-40-55-9 would be helpful. In the table below, we suggest some basic questions preparers could ask themselves relative to the nature, frequency and magnitude of the planned actions that could assist preparers and auditors in making this evaluation.

<b>Management Plans</b>	<b>Nature of the Plans</b>	<b>Frequency of Actions</b>	<b>Magnitude of the Plan</b>
Sale of an asset or group of assets	<ul style="list-style-type: none"> <li>Are the assets being sold consistent with prior disposals of similar assets?</li> </ul>	<ul style="list-style-type: none"> <li>Are sales of assets common?</li> </ul>	<ul style="list-style-type: none"> <li>Are the assets to be sold significant to the entity’s operations?</li> </ul>
Restructuring	<ul style="list-style-type: none"> <li>Is the proposed restructuring consistent with prior restructurings?</li> </ul>	<ul style="list-style-type: none"> <li>Does the entity have a history of restructuring?</li> <li>How often has the entity been restructured?</li> </ul>	<ul style="list-style-type: none"> <li>What impact will the restructuring have on the size of the overall business?</li> </ul>
Raising capital	<ul style="list-style-type: none"> <li>Has the entity undertaken similar capital raising activities in the past?</li> </ul>	<ul style="list-style-type: none"> <li>Does the entity have a history of raising capital?</li> <li>If so, how often?</li> </ul>	<ul style="list-style-type: none"> <li>Will the capital infusion significantly change the capital structure of the entity?</li> <li>Are there any other actions that management will need to undertake as a condition of infusion of the capital?</li> </ul>

Cutting costs	<ul style="list-style-type: none"> <li>• Is the cost cutting consistent with management's plans for the business?</li> </ul>	<ul style="list-style-type: none"> <li>• Has the entity undertaken similar cost cutting measures in the past? If so, how often?</li> </ul>	<ul style="list-style-type: none"> <li>• Are the proposed cost cutting measures significant in terms of overall costs?</li> </ul>
Refinancing debt	<ul style="list-style-type: none"> <li>• Has the entity refinanced debt in the past?</li> <li>• Are the terms of the refinancing being sought by the entity similar to those currently being granted to comparable entities in the industry?</li> <li>• If a potential lender has been identified, does the entity have prior experience with that lender?</li> </ul>	<ul style="list-style-type: none"> <li>• Does the entity have a history of successfully refinancing debt? If so, how often?</li> </ul>	<ul style="list-style-type: none"> <li>• What portion of the entity's existing debt is the entity planning to refinance?</li> </ul>
Launch a new product	<ul style="list-style-type: none"> <li>• Will the new product be launched in markets in which the entity currently sells products?</li> <li>• Will the product be marketed to new or existing customers?</li> <li>• Is the new product an extension of an existing product line?</li> </ul>	<ul style="list-style-type: none"> <li>• Does the entity have a history of launching new products?</li> </ul>	<ul style="list-style-type: none"> <li>• How much revenue is the new product expected to contribute to total forecasted revenues?</li> </ul>

The CAQ believes that preparers, and auditors, would benefit from FASB incorporating the above considerations into the Proposed ASU, while expanding the application guidance and examples to provide details on how the scenarios described above, individually or in the aggregate, factor into the decision as to whether the situation meets a more likely than not or probable threshold for disclosure.

## DISCLOSURES

The CAQ believes that requiring disclosures whose nature and extent increase as the risks related to the assessment increase, is critical in providing financial statement users with additional perspective on the significant judgments involved in the going concern evaluation. While we recognize that the Proposed ASU aims to incorporate this concept, we believe the requirements in certain areas could be enhanced to provide additional and more useful information.

For instance, in situations where the preparer has concluded that it has met the disclosure threshold outlined in paragraph 205-40-50-3, we believe that financial statement users' understanding of the potential impact of the conditions and events (and related plans) would further benefit from the entity's perspective on:

- The risks to successful execution of its plans; and
- If the overall risks of the identified conditions and events are mitigated below the prescribed threshold by executing plans outside the ordinary course of business, the preparer should also disclose the nature of its plans being outside the ordinary course of business.

Further, to the extent an entity concludes that substantial doubt exists, in addition to the Proposed ASU's required disclosures, and suggested enhancement above, we believe that users of the financial statements would benefit from the following additional disclosures:

- Alternatives that the preparer could consider if its plans were to fail;
- The potential effect of those alternatives on the preparer's financial statements; and
- Implications to the entity that would result if such actions are unsuccessful (e.g., that the preparer may be forced into bankruptcy).

The CAQ recommends that FASB include examples illustrating the scalable disclosures detailed above and has provided disclosure examples within **Appendix A** for consideration.

## **OTHER MATTERS**

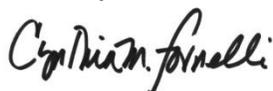
Paragraph BC36 states that if the Proposed ASU was adopted by FASB and similar amendments were made to the auditing standards, "*there would be a lower incidence of audit opinions with an emphasis of matter discussing going concern than is currently observed in practice.*" We acknowledge that if the Proposed ASU is approved in its current form, adjustments to the auditing standards would be needed, to align with the accounting standards. However, neither the PCAOB nor the Auditing Standards Board of the AICPA has provided context regarding potential revisions to the going concern auditing standard, and it is unclear what impact (if any) such changes would have on the auditor's use of an explanatory paragraph discussing going concern. Therefore, we encourage FASB to consider revising or removing this statement from the Proposed ASU.

Further, the need for guidance regarding appropriate audit evidence is integral for the auditor to appropriately assess management's going concern assertions, and we encourage the PCAOB to take this into consideration as it evaluates potential revisions to the going concern auditing standard.

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We appreciate the opportunity to comment on the Proposed ASU and welcome the opportunity to respond to any questions regarding the views expressed in this letter.

Sincerely,



Cynthia M. Fornelli  
Executive Director  
Center for Audit Quality



cc:

FASB

Russell G. Golden, Chairman  
James L. Kroeker, Board Member and Vice Chairman  
Daryl E. Buck, Board Member  
Thomas J. Linsmeier, Board Member  
R. Harold Schroeder, Board Member  
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Daghan Or, Practice Fellow

PCAOB

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Steven B. Harris, Board Member  
Martin F. Baumann, Chief Auditor

SEC

Paul A. Beswick, Chief Accountant  
Brian T. Croteau, Deputy Chief Accountant

Other

Hans Hoogervorst, Chairman, IASB  
Arnold Schilder, Chairman, IAASB



## **Appendix A- Disclosure Examples**

The following are illustrative examples of disclosures preparers may make. These illustrations do not address all possible variations of disclosures and are intended for informational purposes only. Although we have expressed concerns elsewhere throughout this letter regarding the use of the more likely than not threshold, the thresholds for disclosure as defined in the Proposed ASU have been employed here for convenience.

### **Example 1 – More Likely Than Not Disclosures**<sup>25</sup>

*[Assumptions: The Entity determines there are business or other risks that, in accordance with the threshold determination requirements within paragraph 205-40-50-3(a) of the Proposed ASU, could cause the Entity to miss projections in the future (i.e., 12 months), such that it would violate a debt covenant. This would trigger a debt default and result in all of the debt becoming immediately payable. Such an event would give rise to a severe impact on the Entity's ability to realize its assets and meet its obligations in the ordinary course of business, but does not result in substantial doubt.]*

The Entity evaluated whether there are any known existing conditions and events that would have a severe impact on the Entity's ability to realize its assets and meet its obligations in the ordinary course of business. Based on its evaluation, the Entity determined that the condition described below meets the disclosure requirements, and it is more likely than not, although not probable, that it will default under its Working Capital covenant which could have a severe impact on the Entity's ability to realize its assets and meet its obligations in the ordinary course of business, as the Entity does not have access to sufficient liquid assets to fulfill the debt obligation if it becomes immediately payable. Since the future impact of conditions and events cannot be predicted with certainty, actual outcomes could differ from those anticipated at the time the financial statements were prepared and such differences could be material.

The Entity's conclusion about the likelihood of this event, and the severity of its impact, changed during [reporting period], because of a decrease in the Entity's operating results compared with projections.

As discussed in Note (X), the Entity has outstanding borrowings under its Line of Credit agreement, which contains a Working Capital financial covenant. A violation of this covenant would result in a default under the Line of Credit agreement, which if not cured within an xx day period, would cause all of the outstanding borrowings to become immediately due. As of xx, the Entity was in compliance with the Working Capital covenant. The Entity's current operating assumptions and projections, which reflect the Entity's best estimate of future revenue and operating expenses, indicate that anticipated operating expenditures can be met by utilizing cash flows from operations and the available Line of Credit, without defaulting under the Working Capital covenant. However, the Entity's ability to meet its projections is subject to uncertainties, and there can be no assurance that the Entity will meet its current best estimate projections. The Entity has performed stress tests of its best estimate projections and alternate scenario projections. Several of these projections show a violation of the Working Capital covenant during the second half of the next fiscal year.

A default under the Line of Credit agreement would require the Entity to obtain a waiver from the lender or take actions to refinance outstanding borrowings under the Line of Credit with another financing source. If such alternatives could not be secured, the Entity could be placed into bankruptcy by the lender.

To manage the risk of default, the Entity plans to monitor its performance closely and promptly take actions if actual results differ unfavorably from projections. Such actions could include, for example, headcount reductions and the

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<sup>25</sup> This example is based on a scenario in which the Entity's plans do not mitigate the impact of the identified event or condition below a **more likely than not** threshold. To the extent the Entity undertook plans outside of the ordinary course of business to address the risks posed by the identified event or condition; similar disclosures would still be required.

termination of certain contracts to reduce costs. Such actions, if successful, would improve working capital. However, the successful execution of these plans, and the resulting expected improvements in working capital, are subject to risks related to changes in the Entity's industry as well as the Entity's ability to effectively execute them in a timely manner.

### **Example 2 - Substantial Doubt Disclosures**

*[Assumptions: The Entity determine there are business or other risks, in accordance with the threshold determination requirements within paragraph 205-40-50-3(b) of the Proposed ASU, that make it **probable** that the Entity will miss projections in the future (e.g., 24 months), such that it would violate its debt covenant. This would have a severe impact on the Entity's ability to realize its assets and meet its obligations in the ordinary course of business and considering all actions that management could take, there is substantial doubt about the entity's ability to realize its assets and meet its obligations.]*

The Entity evaluated whether there are any known existing conditions and events that would have a severe impact on the Entity's ability to realize its assets and meet its obligations in the ordinary course of business. Based on its evaluation, the Entity has determined that the condition described below meets the disclosure requirements since it is **probable** of having a severe impact on the Entity's ability to realize its assets and meet its obligations. Even after considering the nature of all of the plans described below, there is *substantial doubt* about the entity's ability to continue as a going concern within 24 months after the financial statement date.

The Entity's conclusion that substantial doubt exists changed during [reporting period]. This was because of a continued significant decrease in its operating results compared with projections, a significant deterioration in credit markets and preliminary indications that the lender may not provide a waiver, or additional financing, under satisfactory terms, if the Entity defaults under the line of credit agreement, as discussed below. The Entity acknowledges that, because the future impact of conditions and events cannot be predicted with certainty, actual outcomes could differ from those anticipated at the time the financial statements were prepared and such differences could be material.

As discussed in Note (X), the Entity has an outstanding balance of \$X with \$Y remaining available under its Line of Credit agreement, which is used to fund operations. The Line of Credit agreement contains a Working Capital financial covenant, which is set at X, Y, and Z for the reporting periods ended [date], [date], and [date], respectively. A violation of this covenant would result in a default under the Line of Credit agreement, if not cured within xx days. As a result of [the current trends in the Entity's industry, increased competition, the ineffectiveness of the Entity's marketing and distribution strategies, lack of growth, loss of key personnel and/or risks to intellectual property,] the Entity no longer believes it will be able to meet its previous projections and it is **probable** that the Entity will default under its Working Capital covenant in [reporting period], as current projections indicate that the actual working capital, as calculated under the Line of Credit Agreement, may range from Y to Z [range would indicate that the Entity would fail to meet the covenant].

If the Entity were unable to obtain a waiver or amend this covenant, the Entity would be considered in default under the Line of Credit agreement. Any default under the Line of Credit Agreement may result in the lender discontinuing lending, and declaring all outstanding borrowings due and payable. If any of these events occur, the Entity would need to find additional or alternative financing, if available, to refinance the accelerated obligations. Preliminary negotiations indicate that it is **probable** that such financing will either not be available, or not be available under satisfactory terms, which would have a severe impact on the Entity's ability to operate its business, its results of operations, its financial condition, and its cash flows.

To manage the risk of defaulting under the Working Capital covenant, the Entity plans to monitor its performance closely and promptly take the following actions if actual results differ unfavorably from projections (some of which are outside the ordinary course of business):

- Strengthen its processes in the supply chain and improve productivity.
- Significantly reduce the workforce to lower costs, eliminating poorly-performing sales teams.
- Collect aged receivables and increase the timeliness of billings to improve working capital.
- Develop a strategic plan to exit non-strategic activities and focus on profitable activities.
- Terminate certain contracts.

If these actions are successful, the Entity believes it will improve working capital by \$C to \$D and increase cash flows by \$E to \$F. However, these actions will likely result in a short-term increase in severance expenses ranging from \$X to \$Y, and other one-time contract termination costs, ranging from \$A to \$B. These amounts would be in addition to the amounts already incurred during [period], which are discussed in Note X.

The successful execution of these plans, and the expected improvements in working capital, are subject to risks in the Entity's industry, specifically, the effectiveness of the Entity's marketing and distribution strategies, internal growth, retention of key personnel and protection of intellectual property. There is no assurance that the Entity will be able to manage these risks. If such alternatives could not be secured, the Entity could be placed into bankruptcy by the lender.

Such actions, if taken, would also likely increase the cost of capital and adversely affect the Entity's ability to operate its business, its results of operations, its financial position, and its future cash flows. Specifically, a further increase in the Entity's cost of capital, or the terms of any new financing, would likely result in further impairment of its assets, increases in interest expense, and decreases in cash flows. Sales of operations could further reduce revenues, gross margin, and other key performance metrics.