



## AMERICAN ACCOUNTING ASSOCIATION

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Technical Director, FASB  
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Thank you for giving us the opportunity to remark on the Proposed Accounting Standards Update – Presentation of Financial Statements (Topic 205), *Disclosure of Uncertainties about an Entity's Going Concern Presumption*. Please refer to the attached letter for our comments.

Sincerely yours,

A handwritten signature in blue ink, which appears to read 'T. Jeffrey Wilks'. The signature is stylized and fluid.

T. Jeffrey Wilks, Chair  
Financial Reporting Policy Committee of the  
Financial Accounting and Reporting Section,  
American Accounting Association

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Proposed Accounting Standards Update – Presentation of  
Financial Statements (Topic 205)  
Disclosure of Uncertainties about an Entity’s Going Concern Presumption

Financial Reporting Policy Committee of the American Accounting Association’s  
Financial Accounting and Reporting Section

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## INTRODUCTION AND GENERAL FEEDBACK

The Financial Reporting Policy Committee (hereafter, the Committee or FRPC) of the Financial Accounting and Reporting Section (FARS) of the American Accounting Association (AAA) is charged with “evaluating official standard-setting releases related to financial accounting and reporting as they are released...and providing timely, substantive, and constructive written feedback that is grounded in relevant academic research.”<sup>1</sup> We appreciate the opportunity to respond to the Financial Accounting Standard Board’s (FASB’s) *Proposed Accounting Standards Update – Presentation of Financial Statements (Topic 205): Disclosure of Uncertainties about an Entity’s Going Concern Presumption* (hereafter, proposed ASU) (FASB 2013).

Before responding to specific questions in the proposed ASU, we want to provide general feedback and a summary of existing research related to disclosures about going-concern uncertainties. Unfortunately, although disclosure about general risks and uncertainties has been required since 1995 (SOP 94-6), there has been little academic research to date that focuses specifically on management disclosures about going concern uncertainties. However, we will mention a few studies here that shed some light on the usefulness of such disclosures.

A recent study by Mayew et al. (2013) explores the role of textual disclosures in the MD&A section of a firm’s SEC 10-K filing to predict a firm’s ability to continue as a going concern. Using a sample of firms that filed for bankruptcy over the period 1995-2011 and a matched set of control firms, they found that both management’s opinion about going concern stated in the MD&A and the linguistic tone of the MD&A provided

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<sup>1</sup> American Accounting Association (2012).

significant explanatory power in predicting whether a firm would cease as a going concern. They also found that the predictive ability of MD&A disclosure was incremental to financial ratios, auditor going concern opinion, and market-based variables. They found that the information in MD&A disclosures was more useful in predicting bankruptcy relative to financial ratios three years prior to bankruptcy. They state that this result suggests that MD&A disclosures are more timely than financial ratios and hence, a leading indicator of going concern problems.

While there is little academic research on management disclosures of going concern uncertainties, there is a large academic literature that examines audit opinions modified for going concern uncertainty (see Carson et al. 2012 and Gissel et al. 2010 for recent detailed reviews of the literature). We provide a brief summary of this literature below. In particular, we focus on the subset of the research that examines the presence of auditor bias in assessing going concern uncertainties and the relationship between a company's failure and whether the prior audit report was modified for going concern uncertainty. We think this literature should be useful to the boards because it suggests ways in which management may also be biased in assessing their firm's going-concern uncertainties.

In their synthesis of this literature, Carson et al. (2012) note that audit reports modified for going concern uncertainty increased in recent years. Specifically, the number of companies with audit reports modified for going concern uncertainties increase from a range of 14% to 16% during the period 2002 to 2006 to a range of 19% to 21% during the financial crisis period of 2007 to 2009. The causes cited for these going concern modifications were operating losses, working capital inadequacy, deficits in

retained earnings, short corporate operating history or increased threats from competitors (Cheffers et al. 2010). Other research shows that the likelihood of auditors issuing audit reports modified for going concern uncertainties increases around the passage of regulations, however the increase is short-lived (see section 2.2 in Gissel et al. 2010)

There is also a stream of academic research that examines the relationship between issuing an audit opinion modified for going concern uncertainty and auditor independence (see section 3.3 in Gissel et al. 2010). Within the U.S. the results are mixed as to whether auditors with independence issues are less likely to issue an audit report modified for going concern uncertainties. However, in other jurisdictions, such as the U.K. and Australia, the research provides consistent results that auditors with independence issues are less likely to issue a going concern opinion. This research, along with the changing frequency of issuance of opinions modified for going concern uncertainties, suggests that auditor bias may be a concern in assessing going concern uncertainties.

Much of the research related to going concern modifications uses bankruptcy filing as evidence of financial distress that would have been signaled by a going concern modification. During the period 2000 to 2009 slightly more than half (51% to 59%) of companies filing for bankruptcy received a modified audit report for going concern uncertainty in the year prior to filing for bankruptcy. An increased rate was observed only during the 2002-2003 time period, when 72 percent of firms received a going concern qualification of their audit opinion in the year prior to filing for bankruptcy (Feldmann and Read 2010).

There are fewer studies about first-time opinions modified for going concern uncertainty. Those studies indicate that approximately 80 to 90 percent of companies that receive a going concern modification in their audit report do not fail in the coming year (e.g., Geiger and Rama 2006). However, this result does not appear to hold for a longer time frame. In a longitudinal study from 1983 to 1991, Nogler (1995) found that 33% of firms that received audit opinions modified for going concern uncertainty ended up filing for bankruptcy and an additional 32% were acquired or merged within five years.

While there is evidence of a positive relationship between a company receiving a modified audit report for going concern uncertainty and future bankruptcy, it is not clear what the incremental contribution is beyond other financial information about the company. Carson et al. (2012), in their review of past studies, indicate that companies that: are less profitable, have higher leverage, have lower liquidity, and are in default are more likely to have an audit report modified for going concern uncertainty. They also state that market variables such as stock returns and return volatility are strongly associated with the auditor's decision to issue a going-concern opinion. Furthermore, there is inconsistent evidence as to whether there is a self-fulfilling prophecy (i.e., the going concern opinion increases the likelihood of a business failure) in the issuance of such reports.

The research about going concern qualifications in audit reports does not directly address management disclosures of going concern uncertainties, however it provides evidence about the auditor's assessment of a company's ability to continue as a going concern and subsequent evidence of financial distress through bankruptcy filings. While our committee is unable to provide an overall opinion on the proposed ASU due to the

lack of research, in the next section, we provide the results and implications of academic research that addresses specific questions raised in the proposed ASU.

## **RESPONSES TO SPECIFIC QUESTIONS IN THE EXPOSURE DRAFT**

In this section we address the questions posed in the proposed ASU. We only respond to those questions for which there is academic research that supports a particular viewpoint.

***Question 1:** Do you agree with the proposed definition of the going concern presumption?*

Although there is no specific academic research to address the definition of the going concern presumption, we note that the definition is consistent with the definition used in the auditing standards (AU 341) and we believe that it is important for management and auditors to operate from the same going concern presumption. Most academic research that examined going concern modifications in auditor reports has used bankruptcy filing as an indication that the inherent presumption “that an 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” has been violated (e.g., Chen and Church 1992; Foster et al. 1998; Geiger and Raghunandan 2001). While this is more restrictive than the proposed going concern definition, the research still provides insights that may be useful to the Board in its deliberations.

***Question 2:*** *Should management be responsible for assessing and providing footnote disclosures about going concern uncertainties? If so, do you agree that guidance should be provided in U.S. GAAP about the timing, nature, and extent of footnote disclosures about going concern uncertainties for SEC registrants and other entities? Why or why not?*

As cited above, Mayew et al. (2013) find that management's disclosures about going concern uncertainties are informative in predicting bankruptcy. However they find that over 60 percent of firms that file for bankruptcy one year after filing their 10-K do not provide a disclosure about going concern uncertainties. Given the potential usefulness of the disclosure identified in Mayew et al. (2013) and the lack of companies that voluntarily provide these disclosures, there appears to be an opportunity to improve disclosures about going concern uncertainties.

***Question 3:*** *Would the proposed amendments reduce diversity in the timing, nature, and extent of footnote disclosures and provide relevant information to financial statement users? If so, would the proposed disclosures for SEC registrants provide users with incremental benefits relative to the information currently provided under other sections of U.S. GAAP and under the SEC's disclosure requirements?*

Mayew et al. (2013) find that management's explicit disclosure of uncertainty about going concern is incrementally informative for longer time horizons. In particular, they find that once other financial statement information (including the auditor's going concern opinion) is controlled for, management's going concern disclosure is not incrementally informative in predicting bankruptcy one year out, but it is incrementally informative in predicting bankruptcy two and three years out. This finding supports the FASB's decision to require that going-concern uncertainties be considered for the 24 months following the reporting date.

***Question 4:*** Does management have the objectivity to assess and provide disclosures of uncertainties about the entity's ability to continue as a going concern? How is this different from other assessments management makes in the preparation of financial statements?

The "risk factors" section in the Form 10-K mandated by the SEC requires management to provide objective assessments about significant risk factors. Campbell et al. (2013) show that these disclosures are related to firm risk, showing that management provides risk disclosures that are useful. In this area in which management may be biased, Campbell et al. (2013) show that management is, in fact, objective and provides more than "boilerplate" disclosures. This research appears to support the idea that management also can be objective in reporting going-concern uncertainties.

***Question 12:*** Is the consideration period of 24 months after the financial statement date appropriate? Is it appropriate to distinguish the first 12 months from the second 12 months? Why or why not?

As discussed in our response to question 3, Mayew et al. (2013) find that management's disclosure of uncertainty about going concern is informative in predicting bankruptcy two and three years out. This result supports a 24 month consideration period. This research also suggests that a shorter consideration period, such as 12 months, may not be informative of bankruptcy prediction. We think the proposed ASU represents a reasonable approach because it focuses attention on both the 12 month and 24 month period, with varying probability thresholds triggering disclosure in the two periods.

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