CASE STUDY: ETHICAL IMPLICATIONS OF THE GOING CONCERN PRESUMPTION

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ABSTRACT

This case study explores an entity's going concern presumption and the auditor's going concern warning from an ethical perspective. Ethical decision-making involves both cognitive and emotional reasoning, and is influenced by the moral development and dominant values expressed by individuals. Individuals may disagree on the most ethical decision depending upon which ethical philosophy is applied to the situation. This case presents a biopharmaceutical company in the opening vignette as a guide for identifying some of the potential issues related to the going concern presumption. The history of the going concern presumption follows the opening vignette.

OPENING VIGNETTE

Established in 1991, Cell Therapeutics, Inc. (CTI) is a biopharmaceutical company headquartered in Seattle, Washington with two subsidiaries: Systems Medicine LLC and Aequus BioPharma, Inc. [4]. Founders included financial executive, Louis Bianco, and two oncologists: Drs. James Bianco and Jack Singer. The company's focus is on cancer therapy and the CEO's letter in the 2007 Annual Report noted the company's interest in progressive new cancer treatments using the human genome. The company went public on March 26, 1997 and is traded on both The NASDAQ Capital Markets and the Mercata Telematico Azionario (MTA) in Italy. According to the 2012 Annual Report, the company employs 111 employees in the U.S. and three individuals in Europe. In order to ensure the production and distribution of quality products, the company controls the entire manufacturing process. The company website also noted the company's commitment to community involvement especially with charities related to cancer awareness and assistance such as Ronald McDonald House and Gilda's Club

Biopharmaceutical companies are working capital intensive entities due to the high costs of research and development activities necessary to develop and test new drugs. Operating as a publicly-traded company potentially creates the ability to raise necessary financial resources in the financial markets. As of May 2012, CTI's stock price was $.84 [17] and the company had earlier received warnings that the stock might be delisted. (The NASDAQ requires a minimum stock bid of $1.00 in order for continued stock trading on the exchange.) By September 2013, stock prices were $1.67 [17].

Citing working capital and cash flow problems related to high operating costs, CTI's auditors have included a going concern warning in their annual audit reports. (The going concern warning indicated that the auditors had significant doubt about the entity's ability to remain in business beyond one year – see further discussion below.) Audit reports available on CTI's websites for 2007, 2008, and 2009 (audited by Stonefield Josephson, Inc. of San Francisco) along with 2010 and 2011 (audited by Marcum LLP of San

Francisco) included going concern warnings. The 2012 audit report from Marcum LLP no longer included a going concern warning.

GOING CONCERN

A basic underlying accounting assumption is that an entity is a *going concern.* In other words, there is no planned ending date for the entity and it can be assumed that operations will continue indefinitely. As described by the International Auditing and Assurance Standards Board (IAASB):

> Under the going concern assumption, an entity is viewed as continuing in business for the foreseeable future. General purpose financial statements are prepared 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. [11, para. 2]

The going concern assumption is applicable to all entities including sole proprietorships, partnerships, corporations, state and local governments, and non-profit organizations. Indicators that might suggest an entity would be unable to continue as a going concern include operating losses, working capital deficiencies, loan defaults, inability to pay dividends, loss of important suppliers or customers, adverse trends in financial ratios, loss of patent rights, and losses from natural disasters [1].

The going concern assumption places additional burdens on auditors as they must evaluate the likelihood that the auditee will be a going concern. Auditors have similar responsibilities under International Auditing and Assurance Standards Board (IAASB) auditing standards, Public Companies Accounting Oversight Board (PCAOB) auditing standards for publicly-traded companies in the U.S., and the American Institute of Certified Public Accountants (AICPA) auditing standards for non-publicly traded U.S. entities. According to the AICPA's auditing standard, SAS No. 59 (AU section 341), *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern:*

> 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). [1, para. .02]

Therefore, for purposes of an audit, the assumption is that an entity should remain viable for a period of up to one year beyond the date of the financial statements under audit. Auditors' conclusions are reached after considering management's plans to rectify any identified problems. Although the auditors are not required to modify the standard audit opinion on the fair presentation of the financial statements (a clean or unmodified opinion may still be issued), the auditors must add an additional emphasis of matter paragraph if substantial doubt exists about the entity's ability to continue as a going concern. The additional paragraph specifically states that there is doubt about the entity's ability to continue as a going concern and includes the reasons such as continued operating losses.

HISTORY OF THE U.S. AUDITING STANDARD

External auditors evaluate an entity's disclosure and presentation of financial statement information which provides financial statement users the ability to make sound decisions. In other words, auditors determine if the financial statements provide verifiable and reliable information that is useful for readers in their analysis and decision making related to an entity. The AICPA's Commission on Auditors' Responsibilities [5] concluded that auditors should not make mention of going concern unless the company did not adequately disclose information in financial statements. However, in response to the "expectations gap," the first auditing standard in the U.S. that specifically addressed the auditor's responsibilities related to the

going concern evaluation (SAS 34) was issued in 1981 [3]. The current standard, SAS 59, was issued in 1989. PCAOB, established as the auditing standard setting body for publicly-traded companies in 2002, currently uses the guidance in SAS 59.

CURRENT ISSUES

In 2003, approximately 700 companies received going concern warnings [16]. By 2008, the audit reports of 3179 publicly-traded companies included going concern warnings [8]. Since this record number, there has been a decrease in the number of going concern warnings. Some companies that received earlier warnings choose to delist [12], and approximately 25% of companies that received warnings did not have a similar note in the following year [8]. Improvements for a company were not always permanent, resulting in some future years that included warnings while others did not [12]. Audit Analytics reported that approximately 18% of publicly-traded companies, for a total of 2636 companies, received a going concern warning in 2010, with approximately 98% of that number representing small firms [12]. In many cases, the going concern warnings were issued in response to net operating losses [8].

Since 2000, the numbers of companies that filed for bankruptcy and the amount of assets involved have been unprecedented [16]. Companies that represented the largest 12 bankruptcies in 2001 and 2002 all received an unqualified opinion on their financial statements that did not include a going concern warning. In fact, since 1989 when SAS 59 became effective, only about 50% of companies that went bankrupt received a warning.

Going concern warnings can highlight important information for investors such as the KPMG audit report of West Penn Allegheny Health System, a significant issuer of municipal bonds, that included a going concern warning [13]. However, research studies have shown “mixed results” about whether or not going concern opinions add value to decision making [3]. Critics are concerned that the warnings are overused or are not predictive. For example, GM’s auditors, Deloitte Touche, had noted operating losses and insignificant cash flows; Delta Airlines previously received going concern warnings; KPMG cited problems with debt covenants, cash flows, and profitability in Lee Enterprises’ audit report; and Six Flags was among the companies with going concern warnings [9] [10]. At times, the information appears to have been ignored as in the recent case of Solyndra, a solar-energy company in California, that received over $500 million in federal loan guarantees shortly after PricewaterhouseCoopers LLP issued an audit opinion containing a going concern warning [15]. Along with issues concerning overuse and the predictive ability of going concern warnings, some have questioned whether disclosures based upon a 12 month window are appropriate given an entity’s ability to adequately respond to problems in that timeframe [14] [16].

Although auditors evaluate management’s plans for those entities experiencing financial difficulties, management of U.S. entities have not been required to evaluate and disclose going concern issues. In 2012, the Financial Accounting Standards Board (FASB) reaffirmed its position that management should not be required to specifically disclose this prospective information [7]. At the same time, International Accounting Standards (IAS) 1 required management to make an assessment of going concern [11]. A PCAOB advisory group posited that management should make a going concern assessment because management is responsible for the financial statements, and the CEO and CFO must certify the accuracy of the statements [14]. The advisory group recommended developing industry performance metrics and suggested that management disclose an entity’s individual results [2] [14].

In 2013, the FASB reversed its earlier position and presented an exposure draft that would require management to disclose uncertainties about an entity's going concern presumption. The proposed guidance would require footnote disclosures under either of the following conditions:

> (1) *more likely than not* 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 or (2) *known or probable* that the entity will be unable to meet its obligations within 24 months after the financial statement date without taking actions outside the ordinary course of business. [6, p. 2]

Footnote disclosures would include:

(1) the principal conditions and events that give rise to the entity's inability to meet its obligations
(2) the possible effects those conditions and events could have on the entity
(3) management's evaluation of the significance of those conditions and events
(4) mitigating conditions and events
(5) management's plans that are intended to address the entity's potential inability to meet its obligations" [6, p. 2].

In addition, SEC filers would be required to specifically disclose in the footnotes whether there is substantial doubt about the entity's ability to continue as a going concern.

DISCUSSION ITEMS

1. What are the ethical implications (if any) related to the going concern presumption and the auditor's going concern warning?
2. Who are the potential stakeholders involved?
3. How does one's ethical worldview (e.g., utilitarianism, Kant's Categorical Imperative, or virtue ethics) influence the decision?
4. What implications (if any) are there for different types of entities? For example, should the company in the opening vignette receive different treatment compared to other entities?
5. Who should have primary responsibility for evaluating an entity's ability to continue as a going concern? (e.g., management, auditors, or financial statement users)

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