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1-1-1982

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### Recommended Citation

Auditing Symposium VI: Proceedings of the 1982 Touche Ross/University of Kansas Symposium on Auditing Problems, pp. 178-181;

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# **Discussant's Response to SAS 34 Procedures vs. Forecast Reviews: The Gap in GAAS**

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Let me begin by reminding everyone that my comments are conditioned by my background as a professor. I am not constrained by practical experience with going-concern qualifications, and I do not face legal liability for audit deficiencies with respect to going concerns. Thus, my comments may seem naive since they are based on only my reading of SAS 34 and not on attempts to judiciously apply it.

My interpretation of the words of SAS 34 differs from that expressed by Bob Kay. Also, my interpretation is that SAS 34 has clarified and extended the meaning of SAS 2. I presume that the Auditing Standards Board (ASB) wanted to clarify the meaning of going concern qualifications and specify desirable audit procedures. Whether the ASB has succeeded in changing the requirements and meaning in the accounting (and legal) practice environments is another question.

My comments on Bob Kay's paper will be organized into three related categories. These are:

1. An alternative interpretation of the reporting focus of SAS 34.
2. An alternative interpretation of audit procedures required or implied by SAS 34, and
3. The elimination of the "subject to" qualified opinion as it relates to going-concern situations.

## **Reporting Focus of SAS 34**

The focus of the reporting requirements of SAS 34 is clearly on recoverability and classification of assets and classification of liabilities, and not on the entity's ability to continue in existence *per se*. In paragraph 1, SAS 34 states "When the continued existence of an entity is imperiled, there is heightened concern about the recoverability and classification of recorded asset amounts and the amounts and classification of liabilities." That is, the auditor may question the basis of accounting or whether generally accepted accounting principles are appropriate or a liquidation basis is required. The auditor has no responsibility to search for evidential matter relating to an entity's continued existence. If the auditor does not become aware of any contrary information, then under APB Statement No. 4, he or she may assume that the entity will continue as a going concern and not question whether a liquidation basis is the

proper basis of accounting. When the auditor is aware of contrary information for which sufficient mitigating factors are not present, then the auditor's opinion may be qualified as to recoverability and classification. The qualification is not for the ability to continue in existence *per se*, however (see SAS 34, paragraphs 11 and 12). In other words, under SAS 34, the going concern question is not an end but a means to an end which is the validation of an entity's basis of accounting.

The focus on the basis of the historical accounting of the assets and liabilities is consistent with the view that financial accounting reflects the past. Such reflection may require disclosure relating to the basis of accounting for those past events and transactions or, indeed, the presence of subsequent events relating to the past. The focus on the past is in contrast to the future oriented thrust of Bob Kay's paper in which the auditor must predict the future—i.e., predict whether an entity will continue to exist. This view would require forecasting and some attestation related to future events or states.

I realize that the focus expressed by the ASB in SAS 34 may differ from the common interpretation of a going-concern qualification (or the lack thereof) in the financial community. Also, the courts may indeed, in some cases, interpret the auditor's responsibilities differently than SAS 34 seems to indicate. Certainly, such predictions about the future of the company would be of potential benefit to users of financial statements. The question is whether the auditors are well situated to take such responsibility. Since they do not seem to be so situated, I suggest that we should drop discussion of how the financial community might misinterpret SAS 34 and try to reinforce its "correct" interpretation, perhaps through an education program.

### **Audit Procedures Required or Implied by SAS 34**

SAS's are interpretations of generally accepted auditing standards and as such are related to the legal requirements of a "standard" quality audit required under the securities acts and most contracts for audits. Thus, the SAS's (and SAS 34) are important in assessing the auditor's responsibilities. Also, according to its charge the ASB must consider the cost and benefits of particular statements on standards. Bob Kay seems to say that 1) SAS 34 is too vague as to required procedures; 2) the auditor may be held to a standard of more work than is explicit in SAS 34 and, 3) the level of work is likely to be the level indicated in the AICPA's forecast guide.

Most of the audit procedure requirements of SAS 34 are preceded by a "should consider" modifier. The "should consider" modifier is generally used when the ASB believes that the cost benefit test does not support the conduct of the procedure in every case. In some cases the conditions may, indeed, warrant the application of the forecast guide's level of procedures and the auditor "should" apply that level. In other (and probably most) cases, the guide's level of procedure is not needed and the auditor would be justified in using his or her judgment to perform at a lesser level. The "should consider" requirement places the auditor on notice that substantial work may be needed in some cases, however.

Even if we accept the premise that audit procedures at a level greater than that set by SAS 34 are needed, it is not clear that the forecast guide is

particularly relevant since 1) in SAS 34, the auditor's considerations relate to management's plans which may not include specific forecasts and, 2) the object of prediction is different. In a SAS 34 situation, the immediate object of prediction is the entity's "ability to continue in existence" which is much different from a predicted number for earnings or assets. The continuation in existence prediction is in some cases easier and in other cases harder than prediction of a future accounting number. For example, some firms may need to justify a prediction of positive short term cash flows—it is easier to predict that cash flows will be greater than or equal to zero than it is to predict the exact amount of such flows as in a forecast. In other cases, future short-term cash flows may clearly be positive but the continued existence of a firm may depend on the willingness of bankers and other creditors to continue to provide a line of credit. Examples of both types of cases can be provided from the current financial press.

If auditors are to be held to a higher level of procedure than is required for a particular purpose by a particular pronouncement, then chaos may result. Allan Winter has conducted an analysis of current AICPA-sanctioned services by auditors and has found 19 different levels of assurance. These include assurance from "full" audits, SAARS compilations and reviews, quarterly and segment reviews, reviews of supplemental information and reviews of forecasts and projections, among others. One could argue that an auditor conducting a SAARS compilation is well advised to conduct "full" audit procedures since some court may inappropriately construe such a standard after the fact. I believe that the appropriate approach is for the standards setting body to reason out the economical level of procedure required *ex ante*, educate the users (and courts) as to the responsibility the practitioner is taking, and then *ex post* vigorously defend the practitioner who has applied the predetermined level of service.

### **Elimination of "Subject to" Opinions and the Non-going Concern**

The ASB's current proposal to eliminate subject-to opinions for uncertainties would also apply to going-concern uncertainties. Basically, the proposal says "If in the auditor's judgment the financial statements are prepared in conformity with generally accepted accounting principles, including informative disclosure of uncertainties, then he or she should give an unqualified opinion." A lack of GAAP presentation would continue to require an "except for" qualification. The same requirements would apply in going-concern situations. Footnote disclosure of the question of the basis of accounting and the potential effect on recoverability and classification of assets and classification of liabilities would suffice.

Thus, the proposed elimination of subject-to opinions for uncertainty would require little change in thinking for those who believe that the correct focus of financial statements is on the past with prediction of the future only to assess the appropriateness of the basis of accounting for the past. These persons will not be disturbed by the proposed elimination. Those who believe that the auditor should take more responsibility for predicting the continued existence of firm *per se* will probably be quite disturbed by the proposed elimination.

In summary, I thank Bob Kay for stimulating my thinking about the particular question at hand and the relationships between GAAS, SASs, less

authoritative pronouncements, and the law. I believe that I have clarified some of my own thinking about these relationships. My conclusions as to the particular issues raised, however, differ substantially from those expressed in Bob's paper.