Going Concern: Who is Concerned?

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The Going Concern (GC hereafter) assumption is fundamental to accounting. Until a firm's liquidation becomes imminent, accounting and disclosure choices rely on the assumption that a firm will continue as a GC into the foreseeable future. GC is also the key to the governance of an entity.

In August 2014, the Financial Accounting Standards Board (FASB) issued *Update No. 2014-15 - Presentation of Financial Statements – Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern* (ASU 2014-15 hereafter). ASU 2014-15 requires management to evaluate whether there are conditions or events that raise substantial doubt about an entity's ability to continue as a GC, for each annual and interim reporting period. Management should also consider and discuss the effectiveness of any mitigation plan that can potentially alleviate the GC uncertainties.

Reacting to this new accounting standard, Sears Holdings Corp (Sears) incorporated a discussion of GC in the notes of the 10-K filed in 2017: substantial doubt exists related to the company's ability to continue as a GC due to years of losses and declining sales. As soon as the report was filed with the SEC, the company experienced a drop in stock price by 17.6 percent in premarket trading. The impact of the new GC standard can be seen in this case. More generally, how does the market react to GC disclosures indicating "substantial doubt in GC exists"? This is the first research question I address.

Management is inclined to withhold bad news due to career and equity-wealth related concerns (Bergstresser and Phillipon 2006; Kothari, Shu, and Wysocki 2009), so management disclosures of negative news tend to be more credible than positive news (Williams 1996; Mercer 2004). Consequently, management acknowledging “substantial doubt in GC exists” indicates that issues are severe and the firm’s future viability is highly uncertain. Using three-day cumulative size-adjusted returns to proxy for market reaction, I find that the market reaction is significantly more negative for annual and quarterly filings indicating that substantial doubt in GC exists, compared with filings that do not suggest GC uncertainties.

After the GC uncertainty disclosures, Sears’s management was taking numerous measures to increase liquidity and resolve the financial distress. Just like Sears, firms typically undertake a series of actions to address GC uncertainties. The effectiveness of different types of management plans may vary. Which type of management plan do investors interpret positively, and thereby mitigate the negative market reaction from disclosure of GC uncertainties? This is the second research question I explore.

I conduct highly detailed textual analysis to extract words related to management plan discussions and categorize the words into different types of plans. I construct a dictionary, which contains lists of keywords used to describe each management plan. I find that plans intended for increasing liquidity and plans that lead to operational changes are positively associated with market reactions. That is, investors interpret the effectiveness of these plans positively. In a follow-up test using detailed subcategories of plans, I find that selling of assets, obtaining funds and grants from government and other institutions, raising debt or equity, and reducing operating costs are positively associated with the market's reaction.

A year after Sears started disclosing GC uncertainties, the company's stock faced a major risk of delisting from the Nasdaq. In October 2018, Sears filed for Chapter 11 bankruptcy. The third research question in my paper is to test whether management disclosures of GC uncertainties have incremental power in predicting corporate failures - bankruptcy filing, "Default" in credit rating, and performance-driven delisting - and whether management plans discussed can make a difference in signaling a firm's future viability. Employing a dynamic logit regression at a quarterly interval, I find that management GC disclosures concluding "substantial doubt in GC exists" have incremental power in predicting corporate failures. I further find that "raising debt or equity" and "reducing operating costs" are plans that can alleviate the substantial doubt in GC in the long-term.

The contributions of my paper are as follows. First, my study contributes to our understanding of governance in general. One fundamental goal of governance is to ensure the successful and efficient operation of an entity and protect the entity from business failures. Disclosures of GC uncertainties can erode investors' confidence and significantly lower stock price as well as market value. It is essential for management to take effective actions to address issues existing in operational, financing, and investment strategies. Timely and effective mitigation plans can alleviate the substantial doubt in GC, improve shareholder value, and prevent the occurrence of corporate failures. Such disclosure effect from the adoption of the new GC standard and how to formulate strategies to mitigate GC are essential perspectives for management to consider when designing or modifying the governance system.

Second, GC is fundamental to accounting and the topic of GC has been under heated discussions. With the increase of company failures after the global financial crisis, investors have started questioning the effectiveness of the auditor’s role in providing early warnings of a firm’s financial distress (Edmonds, Leece, and Penner 2016). Regulators and standard setters realize that it is essential to reinforce the management responsibility in assessing GC uncertainties and providing disclosures. Meanwhile, introducing a new GC standard is not uncontroversial and management GC assessment can be subjective. My paper provides initial evidence on the information content of management GC disclosures resulting from the new GC standard.

Third, my study contributes to the textual analysis literature by analyzing and categorizing management plans. I construct a dictionary containing lists of keywords that describe each plan category. Finally, this paper adds to the corporate failure prediction literature. I demonstrate that management disclosures of GC are useful in predicting corporate failures. The management plan discussion features can also shed lights on the firms’ future viability. Such findings can be helpful for standard setters and managers in understanding the effectiveness of different types of mitigation plans.