What is the Going Concern Principle?

Worksheet

Going concern is the assumption that a business will keep operating for at least the next 12 months, which allows assets and liabilities to be measured normally instead of at liquidation value; when that assumption is in doubt, auditors must disclose it.

Questions

1. The going concern assumption means a company is assumed to:
A) Be liquidated within 12 months
B) Continue operating for the foreseeable future
C) Always be profitable
D) Never take on debt

2. Current assets are $600,000 and current liabilities are $900,000. What is the current ratio?
A) 1.5
B) 0.67
C) 0.90
D) 1.0

3. If substantial doubt exists about going concern, what must happen?
A) Nothing - it's ignored
B) The doubt must be disclosed in the financial statements
C) The company must close immediately
D) Only management needs to know

4. Going concern doubt would most likely be raised by:
A) A profitable, well-capitalized company
B) Recurring losses and loan covenant defaults
C) A one-time large sale
D) Paying dividends on schedule

5. A company has current assets of $800,000 and current liabilities of $1,000,000. What does its current ratio suggest about going concern risk?

6. A startup has lost money for 3 straight years and has only 2 months of cash left, with no confirmed new funding. Should going concern doubt be disclosed?

7. A retailer is unprofitable but just secured a confirmed 5-year, well-funded line of credit covering all upcoming obligations. Is going concern still in doubt?

8. Define: What is the going concern principle?

9. Define: Why does going concern matter for asset valuation?

10. Define: What triggers a going-concern disclosure?

Answer Key

1. B) Continue operating for the foreseeable future - Going concern assumes normal continued operations, not liquidation.

2. B) 0.67 - 600,000 / 900,000 0.67, below 1.0, a possible going-concern warning sign.

3. B) The doubt must be disclosed in the financial statements - Auditing standards require disclosure of substantial doubt about going concern.

4. B) Recurring losses and loan covenant defaults - Recurring losses and defaults are classic conditions that raise going-concern doubt.

5. Current ratio = current assets / current liabilities Current ratio = 800,000 / 1,000,000 = 0.8 A ratio below 1.0 means liabilities exceed near-term assets This is a red flag that may prompt a going-concern evaluation

6. Identify conditions: recurring losses + near-term cash shortfall Evaluate management's plans: no confirmed funding yet Conclude substantial doubt exists about continuing operations Yes - a going-concern disclosure is required in the notes

7. Identify the initial condition: unprofitability (a possible red flag) Evaluate management's plan: a confirmed, adequate credit line exists The plan is judged sufficient to alleviate the doubt No going-concern disclosure is required, but the situation should still be monitored

8. The assumption that a company will keep operating for at least the next 12 months.

9. It lets assets be recorded at cost instead of forced liquidation value.

10. Substantial doubt about the company's ability to continue operating, e.g., recurring losses or loan defaults.