Duff & Phelps

The Scarlet Letters: GCO

October 2009

Going-Concern Risk

The Issuance of a Going-Concern Opinion May Be Avoided with Proper Planning and a Well-Developed Campaign to Address the Company's Going-Concern Risks.

When an auditor expresses substantial doubt regarding a company's ability to continue as a going-concern, the stigma can be difficult to overcome despite the real intent behind the underlying accounting rules of merely identifying that substantial doubt exists. Some have called going-concern opinions (GCOs) "self-fulfilling prophecies of doom," whereby the expressed uncertainty of a company's ongoing viability becomes a harsh reality as investors and other key stakeholders interpret a GCO as an indication that a business will fail or go bankrupt within 12 months.

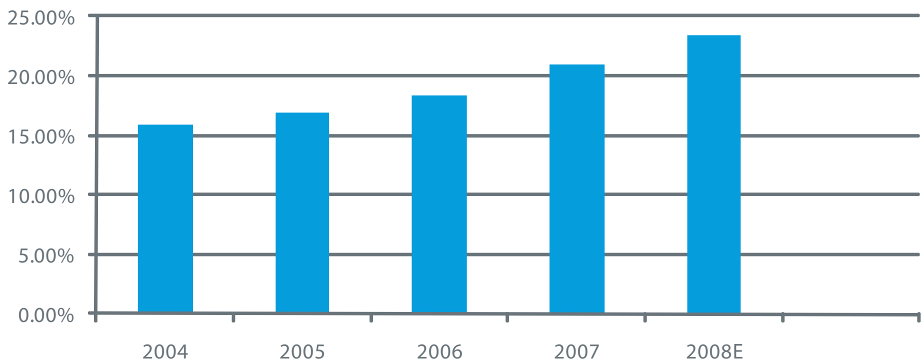
The issuance of a GCO can present immediate concerns regarding the company's ability to meet its liabilities and funding requirements. Other tangible impacts of receiving a GCO may include:

- Depressed equity value
- Loss of credit from trade suppliers
- Customer defections
- Non-compliance with debt covenants
- Acceleration or repricing of outstanding debt
- Inability to obtain additional financing

These costs should not overshadow other less visible but equally damaging effects, such as disillusioned employees and distracted senior management – to say nothing of competitors who may eagerly seize upon the news of a GCO to poach customers and employees and otherwise erode confidence in the marketplace.

Going-Concern Risks and Opinions on the Rise

Due to the current economic climate, more and more companies are facing going-concern risks – many for the first time – resulting in the issuance of an increasing number of GCOs, as indicated in the following chart. This increase not only reflects the current economic climate, but also the growing conservatism of the accounting community, which is acutely aware that caution is a watch word in these uncertain times.



Going Concerns Per Year (% of Auditor Opinions with Going Concern Uncertainty) issued for U.S. public companies

Source: "2008 Going-concerns: A[n] Nine Year Review", Audit Analytics, 2009

The Auditor Going-Concern Decision Process

The professional standards related to going-concern assessment include a relatively straight-forward three-step process for auditors to follow:

- **Step 1:** Consider whether the results of planning, gathering evidence and completing the audit will identify conditions or events that raise substantial going-concern doubt.
- **Step 2:** If substantial doubt exists, (i) evaluate management's plans to mitigate the adverse effects of the conditions giving rise to the doubt and (ii) assess the likelihood that such plans can be effectively and swiftly implemented.
- **Step 3:** Conclude whether substantial doubt exists regarding the company's ability to continue as a going-concern for a reasonable period of time (generally viewed as a one year "bright line" test).

Source: PCAOB - AU Section 341: Auditor's Consideration of an Entity's Ability to Continue as a Going-Concern

While the three-step process is easy to understand, the specific factors considered and the weight attributed to those factors by the auditor in evaluating whether there is substantial doubt regarding a company's ability to continue as a going-concern often involves a complex process.

Research indicates that there is significant confusion in the marketplace about the auditors' going-concern decision process. Common misconceptions (and corresponding realities) include:

Misconception	Reality
Substantial doubt is well-defined in professional literature and is uniformly applied by all auditors.	There is no consensus on the degree of doubt needed to modify the audit report for going-concern. In practice, the definition of "substantial" can vary widely.
Audit firms have a standard formula for quantitatively determining if substantial doubt exists.	Both quantitative and qualitative factors are considered in their evaluation; ultimately the decision of whether to modify their report is highly qualitative.
The audit process and methodology used is objective and results in a high degree of uniformity from one firm to the next.	The process can often be largely subjective and doesn't necessarily produce repeatable results (i.e., the same set of circumstances may result in different outcomes even within the same audit firm).
The audit firm will form its opinion independently and will not be influenced by management.	Audit firms seek to understand management's views and will consider all evidence and data supplied the company. Ultimately, the final decision will be made based on the auditor's best judgment, which will incorporate an appropriate degree of professional skepticism.

The overall increase in GCOs has prompted companies to assess what they can do to mitigate the impact of receiving one or ideally, eliminate the going-concern risks altogether. These are two interrelated objectives, though achieving them requires customized approaches.

Steps to Identify and Evaluate Going-Concern Risks

If a company's financial condition has significantly deteriorated, a GCO may become inevitable. This begs the question, "What early warning signs can be identified and proactively addressed to reduce going-concern risks?" As a threshold matter, as soon as there are any going-concern risk indicators and before an acute financial crisis ensues, companies should consider assembling a working group (sponsored by senior management), including internal cross-functional representatives as well as finance and accounting professionals, who can work collaboratively with an independent, third party financial advisor to:

- Review prior "warning signs" identified by the auditor as well as going-concern conditions and events included in the professional standards (see box below);
- Evaluate and stress-test management's assumptions in its financial forecast for both top-line and bottom-line performance;
- Analyze liquidity and working capital forecasts;
- Conduct a full review of the company's contractual commitments – including trade and credit agreements – considering due dates, payment terms, covenants and other terms
- Examine pending legal and regulatory claims; and
- Consider the results of prior asset and goodwill impairment tests.

Conditions or events included in audit guidance likely to raise going-concern doubts:
Negative trends: recurring operating issues, working capital deficiencies, negative cash from operations, or adverse key financial ratios
Other indications of financial difficulty: loan defaults, denial of usual trade credit, debt restructurings, noncompliance with statutory capital requirements, or the need to seek new sources of financing or dispose of assets
Internal matters: work stoppages, dependence on success of a particular project, uneconomical long-term commitments or significant need to revise operations
External matters: legal proceedings, legislation, loss of key license or patent, loss of principal customer or supplier or uninsured catastrophic event

While this list is not intended to be exhaustive, it nonetheless illustrates the nature of the effort needed to identify and evaluate going-concern risks. An organized, team-based approach to identifying and evaluating these risks is critical to forming management's self-assessment of going-concern risk. A team based approach to going-concern assessment is the leading practice equivalent to a disclosure committee approach to enhancing the quality of a company's financial reporting.

Steps to Mitigate Going-Concern Risks

Assuming management concludes that – despite a company's best efforts – there is more than an insignificant level of going-concern risk, then attention should turn to how best to mitigate the impact of these risks. Here too, a dedicated working group of internal professionals and external advisors may prevent a deterioration of business prospects from developing into a substantial going-concern risk. Key steps in this process include:

- **Development of alternative risk mitigation strategies.** The analytics to evaluate these alternative strategies should focus on both the historical and projected financial statements as well as address the areas presenting the greatest going-concern risk and the strategies that could most effectively mitigate these risks.
- **Enhancement of a company's processes and controls in areas that impact going-concern risk.** Common areas frequently cited by auditors that impact their going-concern determination include:
    - Planning, budgeting and forecasting
    - Liquidity planning and cash management
    - Working capital management

  It is critical that management's key forecast assumptions are both realistic and supported by external validation. Auditors will be seeking to obtain adequate external collaborative evidential matter supporting management's forecast and will exercise a high degree of professional skepticism in evaluating these assumptions.
- **Development and execution of a detailed action plan designed to help management mitigate risks.** This should be articulated to auditors as part of a campaign to strengthen the company's ability to continue as a going-concern. This documented plan should instill confidence that the company is thoughtfully addressing and mitigating the factors that led to its going-concern risk. Common areas addressed in these action plans include:
    - Cost reductions
    - Raising capital
    - Business process improvements
    - Enhanced asset utilization or sale of non-core assets
    - More effective cash and working capital management
    - Stabilizing and growing revenue
- **Implementation of a comprehensive communications program tailored to ensure that key stakeholders (e.g., investors, lenders and customers) are aware of the steps management is taking.**

The earlier a company identifies potential issues and convenes a working group, the faster management can form an effective assessment of its going-concern risks, develop action plans that may more effectively mitigate these risks and stabilize the business and communicate its plans to its auditor. If an entity has already received a GCO, then a working group can assist in mitigating its impact on the business by strengthening the company's ability to continue as a going-concern.

Looking forward, the combination of a potentially long, slow economic recovery and a vigilant auditing profession will likely spur an increase in GCO issuances. As a result, companies are well-advised to adopt a year-round approach to monitoring for going-concern risks and to convene a team of internal professionals and external advisors who are suited for the task of communicating concerns to management.

The immediate and lasting repercussions of unmitigated going-concern risks and the inevitable resulting GCO can be harrowing for a company. But, with appropriate preparation and proper guidance, the letters GCO need not be followed by R.I.P.

DO's and DON'Ts

DO take a year-round approach to monitoring for going-concern risk indicators.
DO convene a working group consisting of internal professionals and external advisors who bring experience, subject matter and technical expertise, sophisticated analytical tools and proven execution skills.
DO be proactive with auditors. Assist them when possible, field questions when raised and work together for a mutually agreed upon outcome.
DON'T approach an audit firm other than your own. To do so would risk violating the "opinion shopping" rules and could represent a reportable matter to your audit committee. This could also damage your relationship with your auditor.
DON'T be passive. A company that waits for its auditor's final going-concern conclusion before addressing its going-concern risks loses valuable time that could be spent developing and executing an achievable action plan that may alleviate or eliminate such risks.

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