

PCAOB

Investor Sub Advisory Group

GOING CONCERN CONSIDERATIONS AND RECOMMENDATIONS

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Auditing standards requiring auditors to issue going concern opinions have existed for several decades. However, research indicates the success with this standard has been somewhat spotty at best.

Our experiences, including as signing audit partners, has been that it takes a significant amount of time, to carefully analyze a company's financial condition, liquidity and results of operations when objectively trying to determine if the company is going to last another year or not. The one year from the balance sheet date has been a very clear standard auditors' and companies fully understand. However, when a significant event would be due to occur shortly after that 12 month period, such as a major debt refinancing being due, or a major customer or vendor supply agreement concluding, it did make one nervous looking to just a twelve month period.

Auditors will typically look at historical results in the last few years, especially trends in the last half and quarter of the year. That would include revenue trends, cash sources and uses, available cash and funding sources, etc. The auditor would look at budgets and projections for the next year, and require management to provide, and go over, their projections and key assumptions going into those projections. The auditor would try to get a handle on the risks in those projections and what things could go awry that would result in more negative results, than were being projected.

More difficult for the auditor was getting data on the industry, competitors and economy and how they would affect a company's financial stability. For example, if peer companies were performing well but the audited company was not, then one wanted to know what the reasons why it was not performing. Was it due to products that were not competitive, a lack of competitive pricing, outdated technology, etc.? Yet sometimes these were very key issues that had to be assessed when deciding whether or not to issue a going concern opinion. And certainly, for those auditors who were cognizant that there was a going concern issue, our experience is they did not treat it lightly due to the concern that if the company failed, and there had not been a going concern opinion, one would be sued.

On the other hand, there have been instances, where it appears for whatever reason, the auditor did not recognize the seriousness of the lack of financial stability of the company. Perhaps the auditor did not focus sufficiently on the cash flows of the entity, and the seriousness that a liquidity event could occur which could bring the company down rather

rapidly. Enron, Worldcom, MF Global and Lehman come to mind. In other instances, a poorly planned audit at the beginning, with too many junior staff assigned, and the audit partner and manager not getting out to the job site until shortly before the audit opinion was due to be released has no doubt contributed to questionable audit reports. Bringing up a going concern opinion for the first time late in an audit and surprising management, usually guaranteed a very difficult, rough and tumble finish to the audit

Our experience has noted management would often push back against the auditor considering the issuance of a going concern opinion and who was somewhat skeptical. Management never did like getting a going concern opinion as it did not reflect well on them, especially if they had been around for a while. Audit committee members were also usually concerned about whether or not it would result in the increased risk of litigation or liability. At times I felt as if audit committees had not always fully understood everything that was going on at the company, industry and economy.

With that as background, our combined thoughts on how to improve the reporting surrounding a company in financial difficulty are as follows.

Key Performance Metrics

There are key performance metrics that each company has, that really tell one how the company is performing. It varies greatly from one company to the next and from one industry to the next. For example, in the semi conductor industry, key metrics included those related to the capacity and utilization of a semiconductor fabrication plant, and the aging of the sales backlog and delivery schedule. A non-fabrication semiconductor company would not have had the same capacity and utilization issues, but would have had a key issue with their fabrication supplier.

One can tell much earlier on whether a company is getting into trouble, especially compared to its peers if key performance metrics are disclosed, and monitored by the investor/portfolio manager/analyst. During the 1990's the FASB and AICPA undertook studies of such disclosures. The SEC had a working group on these disclosures in 2000-01. The Banking regulators and SEC also has the Shipley Committee study such disclosures for financial institutions. It would be beneficial if the SEC and/or FASB were to require disclosures of key performance metrics so as to provide better trend information with respect to the operations and risks of a company.

Definition of Going Concern

The current definition of a going concern in generally accepted auditing standards (GAAS) is:

International Accounting Standards No. 1, paragraph 25 and 26 state:

“25 When preparing financial statements, management shall make an assessment of an entity’s ability to continue as a going concern. An entity shall prepare financial statements on a going concern basis unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so. When management is aware, in making its assessment, of material uncertainties related to events or conditions that may cast significant doubt upon the entity’s ability to continue as a going concern, the entity shall disclose those uncertainties.

26 In assessing whether the going concern assumption is appropriate, management takes into account all available information about the future, which is at least, but is not limited to, twelve months from the end of the reporting period. The degree of consideration depends on the facts in each case. When an entity has a history of profitable operations and ready access to financial resources, the entity may reach a conclusion that the going concern basis of accounting is appropriate without detailed analysis. In other cases, management may need to consider a wide range of factors relating to current and expected profitability, debt repayment schedules and potential sources of replacement financing before it can satisfy itself that the going concern basis is appropriate.”

GAAS states in AU 508.11 that a going concern report is not a qualified report, but rather considered to be a report with supplementary additional information. AU 341, titled “The Auditors Consideration of an Entity’s Ability to Continue as a Going Concern” states in paragraph .02; “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). The auditor’s evaluation is based on his or her knowledge of relevant conditions and events that exist at or have occurred prior to the date of the auditor’s report.”

We find both of these definitions/standards to be lacking. First they set a very high hurdle when they use the words “significant” and “substantial.” Second they set the assumption you are a going concern unless one is in the stage of liquidating, ceasing business, and has no choice but to do so. As a result, the auditor is unlikely to give advance notice in a going concern report, and management is unlikely to provide investors early warning disclosures, until it is too late.

Both of the definitions can and should be improved upon. Since going concern reports have failed to show up sufficiently early to warn investors, we believe the test for issuance of an audit report should be based on a “more likely than not test.”

Previously, the FASB has considered requiring management to make “...early warning disclosures when management, applying commercially reasonable business judgment, is aware of conditions and events that indicate, based on current facts and circumstances,

that it is reasonably foreseeable that an entity may not be able to meet its obligations as they become due without substantial disposition of assets outside the ordinary course of business, restructuring of debt, issuance of equity, externally or internally forced revisions of its operations, or similar actions.”

Accordingly, the PCAOB should revise its standard to be more explicit and require the issuance of a going concern supplementary paragraph when it is *more likely than not* that “the auditor has is aware of conditions and events that indicate, based on current facts and circumstances, that it is reasonably foreseeable that an entity may not be able to meet its obligations as they become due without substantial disposition of assets outside the ordinary course of business, restructuring of debt, issuance of equity, externally or internally forced revisions of its operations, or similar actions.”

We believe the auditors assessment should not be limited to just 12 months from the balance sheet date, as the current auditing standard does. Rather, more consistent with IFRS, in making his or her assessment, the auditor “...should take into account available information about the foreseeable future, which is generally, but not limited to, 12 months from the end of the reporting period. Certain events that are expected to occur or are reasonably foreseeable beyond 12 months that would materially affect the assessment are considered part of the foreseeable future. The time frame beyond 12 months is limited to a practical amount of time thereafter in which significant events or conditions that may affect the evaluation can be identified.” This is language the FASB has previously considered. Unfortunately, the FASB has punted on much of their project and decided not to require early warning disclosures. Nonetheless, we believe the above additional guidance surrounding the twelve month period would greatly benefit investors and transparency in financial statements and disclosures.

Responsibility for Making the Going Concern Assessment

The requirement to assess whether an entity is a going concern or not, should rest with ***BOTH*** the management team, ***AND*** the independent auditors. Management has the primary responsibility for the financial statements, certifies as to their accuracy and accordingly they should have to make the assessment. This should not be difficult in most instances as the company will have a history of profitable operations, sufficient liquidity and capital, and assets they can access to conduct normal operations. It will need to be much more substantive when the financial flexibility, liquidity and condition of the company is threatened. When that occurs, unfortunately, it often reflects negatively on the current management team and board of directors. In those instances, human behavior being what it is, may result in management being reluctant to disclose the problems, as we have seen with companies in the past dozen or so years.

Accordingly, realizing that over time, and consistent with the conclusions of the FASB, that management may be biased and lack objectivity when making a going concern assessment, especially, when times are bad, the external auditor should also be required to bring their independence, knowledge and judgment to the issue. Therefore GAAS (PCAOB) should require the auditor to issue a supplemental going concern paragraph when as discussed above; they have concluded that it is more likely than not “that it is reasonably foreseeable that an entity may not be able to meet its obligations as they become due.”

Auditors Report

Currently, the auditing standard - AU – 341 - requires a going concern report to state:

“The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note X to the financial statements, the Company has suffered recurring losses from operations and has a net capital deficiency that raise substantial doubt about its ability to continue as a going concern. Management’s plans in regard to these matters are also described in Note X. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.”

GAAS does not currently require the auditor to give the significant reasons, assumptions or basis for concluding a company may not be a going concern. GAAS should be explicit and require an auditor to state in their explanatory paragraph the significant considerations that went into his or her conclusion that a question exists as to whether an entity is a going concern.

In Financial Reporting Release No. 16 (FRR 607.02), the SEC states that “...the auditor who issues a report that is qualified as a result of questions about the entity's continued existence must evaluate the disclosure about the financial problems giving rise to the accountant's qualification. The Commission believes that in such cases Paragraph 10 of SAS 34 requires the auditor to include in his report, if not otherwise disclosed in the financial statements, appropriate "disclosure of the principal conditions that raise (the) question about (the) entity's ability to continue in existence, the possible effects of such conditions, and management's evaluation of the significance of those conditions and any mitigating factors." The Commission also believes that paragraph 10 of SAS 34 requires auditors to assure the adequacy of disclosure about plans to resolve the doubts about the entity's continued existence.”

Financial Statements, Footnotes and Accompanying Risk Disclosures

We recommend *the FASB* require better disclosures in the financial statements than what are currently required by Generally Accepted Accounting Principles (formerly SOP 94-6).

These disclosures are required by GAAP to be made *ONLY* when they would occur within the twelve months subsequent to the balance sheet date, and had a “severe impact” on the company which was defined as being more than a material impact. GAAP goes on to say something catastrophic would be a severe impact and something less than catastrophic may also be a severe impact. Unfortunately, in practice, as we saw with the financial crisis, events had to be catastrophic at companies such as AIG before disclosures appeared. By that point in time, it was way too late for investors, and the disclosures when made, only caused the market to go into a panic.

As was originally proposed during the SOP 94-6 project, companies should be required to disclose information regarding their financial flexibility. As set forth in the original SOP 94-6 exposure draft:

“26. Notes to financial statements should include a discussion of management's expected course of action when it is determined that it is at least reasonably possible that the entity will not have the ability over the near term to pay its expected cash outflows without taking certain actions. Such actions include entering into new credit agreements, modifying or renewing existing credit agreements, and other significant actions, such as those described in paragraph 27. This evaluation should be based on information available prior to issuance of the financial statements and of which management is reasonably expected to have knowledge.

27. Examples of expected courses of action that bear on financial flexibility and that may be the subject of discussion pursuant to paragraph 26 are as follows:

- Borrowing, either—
 - a. directly, by borrowing from banks, borrowing from governments, issuing bonds, issuing commercial paper, or
 - b. indirectly, by delaying payments to suppliers or employees, extending due dates of loans, or restructuring loans.

- Liquidating assets, either—
 - a. directly, by selling long-term investments, selling (possibly combined with leaseback) plant and equipment, buildings or infrastructure, or
 - b. indirectly, by not replacing inventory as it is sold through normal trade channels or not replacing fixed assets as they are consumed in operations. Including overcoming any subjective covenants in existing credit agreements that could enable the lender to either accelerate debt maturities, cancel existing credit facilities, or deny borrowing under credit agreements.

- Enacting new taxes or raising existing taxes.
- Reducing costs.
- Reducing dividends.
- Reducing or eliminating services or programs, including deferring maintenance on infrastructure.
- Issuing capital stock.
- Filing for bankruptcy protection.

28. The disclosures in paragraph 26 are required whenever it is at least reasonably possible that the entity will not have the ability over the near term to pay its expected cash outflows without taking certain actions. The extent of the disclosure, however, should take into account the severity of the situation. It would be expected that the disclosures involving an anticipated renewal of an existing seasonal borrowing arrangement (or, for example, recurring issuances of tax anticipation notes by a governmental entity) would be much less extensive than those involving a situation where the entity's present financial condition has called into question the entity's ability to continue as a going concern."

In addition to the above disclosures, if the ability of an entity to continue as a going concern is dependent on financial assistance, directly or indirectly, from a government, than that should be disclosed including the nature, terms and conditions under which such assistance would be provided. This would also include any agreement with the government for forbearance with respect to capital requirements.

These disclosures would be included in the financial statement footnotes based on a reasonably likely determination. That would be a lower threshold than the "more likely than not" which would trigger a going concern report from the auditor. Including these disclosures in the footnotes would result in them being audited, and if an auditor found them to be inaccurate, materially misleading, or omitting material information, the auditor would be required to qualify their opinion stating as much. The above disclosure would also obviously be required if an auditor did include an explanatory going concern paragraph in their audit report.

In summary, we believe that company's disclosures for reporting on events reflecting on their ability to continue as a going concern should be triggered by a "reasonably likely" standard. That standard should be established by the FASB or in their absence, by the SEC. A supplementary paragraph from the independent auditor should then be triggered by the higher threshold of "more likely than not." In this manner, management could provide

investors with adequate red flags regarding risks, before the more serious report was issued by the auditor.

Updating Auditing Standard

The auditing standard as written:

1. Does not set forth the specific objectives of what the standard expects the auditor to achieve;
2. It does not require the auditor to design any part of the audit specifically to look for evidence with respect to going concern. For example, it does not require the auditor to look for evidence that cash flows and cash flow requirements may trigger a liquidity event that could put the company into a tailspin as was the case with companies such as Enron, Worldcom, AIG, Lehman and MF Global. It is only if information comes to the attention of the auditor that an issue exists, that the standard indicates the auditor must then go further;
3. There is no requirement to represent to the auditor that the entity is a going concern;
4. There is no communication requirement for communicating to the audit committee;
5. There is no requirement for the auditor to consider evidence that is available in the public domain, that is contrary to evidence management might have presented. I have found in many instances, the public was aware of the evidence the auditor did not give any consideration to, that later on made the auditor look pretty dumb.
6. There is no requirement for the auditor to gain an understanding of, and evidence with respect to, management's key assumptions with respect to their plans for addressing and mitigating the risks associated with the business that may result in it being more likely than not it will fail.
7. There is no requirement for the auditor to conclude as to whether those key assumptions provide a reasonable basis for management's conclusion - and any conclusion of the audit committee - that the company is a going concern.

As a result of what are at least perceived to be rather serious shortcomings, perhaps best evidenced by the lack of the issuance of going concern reports in some of the ten largest US bankruptcies, as well as companies receiving Tarp Funds, it would appear in order to amend the current standard to:

1. Include a statement of basic objectives the board expects auditors to achieve;

2. The auditor should be required to design the audit to obtain sufficient and competent evidence with respect to whether it is more likely than not that the company being audited is a going concern;
3. The auditor should be required to consider evidence available to them in the public, that is contrary to the evidence provided by management;
4. With respect to management's plans for mitigating the likelihood and entity may not longer be a going concern, the auditors should be required to:
 - a. Gain an understanding of the plan.
 - b. The auditors should obtain a list of, and understand the key assumptions underlying the plan.
 - c. The auditors should gain evidence with respect to whether the key assumptions are realistic as well as complete.
 - d. The auditor should consider whether the key assumptions and data in the plan are consistent throughout the plan.
 - e. The auditor should consider whether there are any key omissions that would have a material impact on the plan and the ability of the entity to continue as a going concern.
 - f. The auditor should consider factors specific to the industry, or competitors that may impact management's plan.
 - g. The auditor should consider past historical trends of the company, such as trends in cash flows and cash cycles, operating costs, revenues, and realization of asset values when assessing management's plan.
5. The auditor should as part of the management representation letter obtained from management, obtain a representation that (a) management is responsible for presentation of its best estimate of its plan, and (2) management's conclusions as to whether or not the company will continue as a going concern.
6. The standard should require the auditor to communicate to the audit committee whether or not they have concerns as to whether it is reasonable to expect the company may not continue as a going concern. If the auditor has a concern with respect to key financial risks of the business, including but not limited to whether the entity will continue as a going concern, the auditor should communicate those concerns to the audit committee, in writing, and the basis for those concerns. As part of those communications, the auditor should communicate to the audit committee as to whether or not they consider the company's disclosures to be appropriate, in light of the evidence they have obtained.

Role of the Audit Committee

The audit committee spends less time at the company, and has less knowledge of it, than the financial management team and may well have less knowledge than the auditor.

Indeed, it is reasonable for members of the audit committee to make reasonable inquiry of such experts and be able to rely on them in doing so and carrying out their oversight and fiduciary duties on behalf of investors.

The auditing standard on communications between the auditor and audit committee should be expanded. The current standard, which is under reconsideration by the PCAOB, should include a requirement that the auditor discuss with the audit committee, the scope of their audit procedures with respect to auditing the going concern assumption, their conclusions reached, and the basis for such a conclusion.

The SEC rules regarding the audit committee report to investors should be updated and revised. It has been over a dozen years since these rules were first studied and adopted. If the auditor has concluded that it is more likely than not that there is a question regarding the ability of a company to continue as a going concern, we believe the audit committee should be required to disclose the process they have undertaken to assess whether the company is a viable going concern as defined above.

Role of the Regulator

Regulators and government officials may have information that reflects in a material way on the financial condition, liquidity, capital and results of operations of a company. Regulators should share such information with the independent auditor. Auditors should also share with regulators information that the regulator may request. This information may be subject to confidentiality laws, but should not preclude material information being disclosed to investors.

Enforcement

Auditing and accounting standards will only provide investors with the information they require, when they are properly implemented and followed by management. The external independent auditor serves as a gatekeeper to ensure they are properly implemented and followed. One of the significant benefits of the Sarbanes-Oxley Act of 2002 was the PCAOB was established, under the oversight of the PCAOB, to examine the work of the auditors to ensure they were fulfilling their obligations and responsibilities to investors as independent gatekeepers. It is important, especially in light of the lack of going concern opinions and risk disclosures during the recent financial crisis that the PCAOB and SEC carry out their enforcement mandate to ensure that GAAS and GAAP are fully complied with, and investors protected.