

Going concerns

How accounting professionals assess a company's future viability **Interviewed by Matt McClellan**

The professionals conducting an audit for a company are not only providing assurance on the company's historical financials, but are also assessing the company's ability to operate in the future. Auditors evaluate the going concern assumption during the audit process and, if there is substantial doubt regarding this assumption, auditors are required to emphasize this in their audit opinion.

Pat Ross, partner with Haskell & White LLP, says that if there are any material uncertainties that may affect the company's ability to survive, members of management need to consider disclosing this in the footnotes to their financial statements, and the auditor needs to consider the impact on his or her audit opinion. "It is a very tough judgment call, and it can be a source of contention between the firm and its client," Ross says. "The auditor would usually have his or her client put forecasts together showing their viability and evaluate the assumptions that are within those forecasts."

Smart Business spoke with Ross about what to do if your auditors doubt your company's ability to continue as a going concern, and how to create a plan to avoid this situation.

What factors determine whether a company qualifies to continue as a going concern?

Generally, it comes down to whether or not your company is able to make money. Depending on the industry, there are different factors that go into that. But typically, accountants will look at whether the company loses money year after year. If they have to go back to the debt or equity market again and again, and if those sources dry up, it can be a challenging situation for the future.

Along with continuing losses and cash flow losses, or the inability to obtain credit, sometimes companies will experience changes in the marketplace, such as adverse technology changes that make their product obsolete or legislation or tax-law changes that could affect their prospects for the future.

Have there been any recent changes to this consideration?

The Financial Accounting Standards Board is currently deliberating a potential change to the accounting rules for when



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and how to disclose information. The general rule as it stands now is to look one year out from the date of the financial statements in making this determination. However, in practice, companies may try to push significant events or conditions that should be disclosed out to the following year if they have no deadline. Then they can say they survived for a year, so there is no need to disclose this situation in the footnotes or note it in the audit opinion. If the proposed change is adopted, the rule will be revised to have management and the auditor consider all available information about the future and eliminate the brightline one-year rule.

What should an owner do if there are doubts the business can continue as a going concern?

Be proactive upfront and discuss any red flags with your auditor before he or she even starts the audit. This includes discussing management's plan to mitigate recurring operating losses or improve cash flow or other items. These problems are usually apparent to management before the year-end audit, so have a discussion with your auditors about what factors they expect to look at to make their determination.

Plan this discussion before the audit begins; for a December year-end, meet in

October or November. If the auditors have raised concerns about your working capital and your line of credit that renews in April, address the risk that the bank might pull away your funding source. Discussing this upfront would provide management the opportunity to go to the bank in February before the auditors finish their audit, and try to renegotiate or renew their line with acceptable terms.

If financials are due March 31 for a December year-end, but these discussions don't happen until the first week of March, it is unlikely the company and the bank will have a signed deal prior to the due date. This uncertainty typically results in the auditors assuming the bank will not extend further credit. Eliminate the subjectivity and allow management sufficient time to remedy any uncertainties.

How can businesses in these situations get back on track?

A lot of it rests on the talent of management to right the ship. Sometimes, especially in this economy, you have to make some hard decisions. Most companies have addressed issues such as reducing headcounts and cutting costs. Today that is not going to be enough, and doing something drastic may be necessary. This is the time for management to make a difference for its stakeholders.

What can executives do to avoid this situation completely?

In this environment, I have been advising my clients that they should have various contingency plans in place. For example, for plan A, they lose 25 percent of customers. What would they do in that situation? Then, have a plan B in which you lose 50 percent of your customers, and create specific action steps for each plan. Look at the consequences and the alternatives and know that, if you get in that situation, you can do X, Y and Z and still survive.

If you wait for those events to happen and are reactive, you're likely to fail because you don't have a plan. It all goes back to the survivability of the company, and what generally keeps companies alive: cash flow and profit. <<

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