Address Going-Concern Issues as Early as Possible

By Duncan Will, CPA/ABV/CFF, CFE

Economic challenges create significant worries for CPA firms and their clients. Ignoring or delaying action in addressing problems (especially financial difficulties) will only allow them to fester and grow. CAMICO recommends facing and tackling the biggest issues as early as possible.

Recent developments within the accounting profession are also influencing the way CPAs approach their duties and responsibilities.

The following scenario illustrates some of the issues involved and the choices facing CPAs as they exercise professional judgment and manage what could become a financial reporting dilemma. All names have been changed.

Diane Prince, CPA, was advised by her client, Jack O. Lantern ("Lantern"), the owner of home builder, Living Large, LLC ("Large") that his local bank wanted compiled financial statements. Lantern has told Prince that the bank knows the books "aren't in great shape," but the bank will be satisfied with compiled financial statements for the prior year end. Prince's firm had already cleaned up the books and prepared Large's tax return for that year.

Large owes $15 million to the bank and another $7 million to Lantern's friends. The friends' loans are unsecured demand notes.

Economic challenges worry Prince, as she understands that should any lenders get cold feet and demand payment, her client would have difficulty obtaining the funds needed to repay the debt. However, Prince is confident that Large will survive the year, as the year end is only a few weeks away.

Prince's firm called CAMICO's Loss Prevention department to discuss the "going concern" implications. The discussion addressed numerous issues.

The issues raised were: 1) whether the client's financial statements should disclose or emphasize the uncertainty regarding the substantial current debt obligations; 2) whether a going concern disclosure was required or even appropriate; and 3) whether a going concern type of disclosure was appropriate when the CPA was nearly certain the entity would survive the year.

It was noted that U.S. GAAP reporting standards don't differentiate between audits, reviews and compilations. The standards specify that if substantial doubt exists about an entity's ability to continue as a going concern for one year after the date that the financial statements are issued (or available to be issued when applicable), this means the ability to survive the year after the balance sheet date is <u>not</u> sufficient. Accountants should consider whether management's plans intended to mitigate the going concern conditions or events are sufficient to alleviate the substantial doubt.

CAMICO encourages CPAs to be critical in assessing the economic challenges facing their clients, management's assessment of the client's ability to continue as a going concern, and the viability of the solutions management has indicated they will pursue to alleviate the doubt about their client's ability to continue as a going concern.

Practitioners will be tempted to limit the going-concern treatment to the 12-month "time horizon" ending on the anniversary of the issuance date, but accountants should inquire of management regarding its knowledge of conditions or events beyond the period of management's evaluation that may have an effect on the entity's ability to continue as a going concern.[1] Such inquiries are not intended to require management to extend its evaluation beyond the requirements of the applicable financial reporting framework. Other than inquiry of management, the auditor does not have a responsibility to perform other audit procedures to identify conditions or events that may raise substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time beyond the period evaluated by management,[2] but should not ignore known conditions or events.

CAMICO recommends that practitioners who choose not to add going concern language to their accountants' reports: 1) insist their clients' financial statements include disclosures detailing the events and circumstances which would impact the going concern assumption, and 2) add an emphasis-of-matter paragraph to their report to draw attention to these disclosures. But remember, emphasis-of-matter paragraphs can't introduce new information — their use is limited to emphasizing matters already disclosed in the financial statements.[3]

In this instance, Prince was leaning towards adding a going concern disclosure, but ultimately settled on adding similar disclosures and adding an emphasis-of-matter paragraph. Even though she wasn't adding a going-concern paragraph to her report, she wished to make financial statement readers aware of the issues. She had two reasons. First, professional standards[4] indicate that once a CPA concludes that doubt about an entity's ability to continue as a going concern for a reasonable period of time is alleviated, the CPA should consider disclosing the conditions and events that caused her to believe substantial doubt existed. Second, and most importantly, it was understood that adding disclosures to the financial statements and an emphasis-of-matter paragraph to her report would better inform financial statement readers. Therefore, Prince convinced Large to add a "subsequent events" disclosure describing: 1) the current economic climate, 2) Large's debt situation, and 3) the economic strains facing Large.

Prince's professional judgment was that a going-concern paragraph was unnecessary, but she still wished to make financial statement readers aware of the issues. She therefore chose to add an emphasis-of-matter paragraph to her report referencing the "subsequent events" disclosure.

Had Prince chosen not to disclose this information, and the financial statement users ultimately suffered a loss, they might later allege that the information was omitted intentionally to mislead

[1] AU-C §570.15, AU-C §570. .A23, .A25–.A27
[2] AU-C §570.A21
[3] AR-C §90.05, Preparation, Compilation and Review Guide ¶1.189 - ¶1.191, and Glossary
[4] AU-C §570.22

them. The burden of proof would then shift to the CPA to explain why she missed what was obvious in hindsight.

Before concluding the discussion, it was agreed that Prince would encourage Large to verify that the compiled prior year's financial statements would meet the bank's needs. It was also agreed that Prince's engagement letter would: 1) describe illustrative reporting language, 2) require Lantern to provide written representations in a format agreed to by Prince; and 3) the financial statement's use would be restricted to Lantern and the one specified lender.

Loss Prevention Tips

Going-concern issues should be addressed as early as possible in an engagement. Don't delay dealing with them until you are trying to wrap up an engagement — that is too late! CAMICO claims history is rich with cases where practitioners, though aware of their clients' financial hardships, procrastinated and chose to ignore or delay recognition of the elephant in the room. Embrace the words "Hello, Dumbo" (or you may later hear the words in a greeting). Delay makes the necessary conversations more difficult, may impair your objectivity, and usually exacerbates the problem. Clients will then claim you've wasted their time and money, as a more flexible, competent and understanding professional would not require the unflattering disclosures.

Also, just because your client says they want a particular financial statement service doesn't mean it's the most appropriate service for them or what third-party users will require. Push back. Find out whether the service being requested will meet the client's and the intended users' needs. If you later discover the service was more or less than optimal, you may find not being paid is only the beginning of your problems.

Use engagement letters to specify the scope and limits of your services as well as your and management's responsibilities. Standardized engagement letters are good templates, but modifications should be made as needed, perhaps including the anticipated language of your report. These determinations cannot always be made until the services have begun. If so, promptly communicate in writing the change in circumstances and consider revising your engagement letter accordingly.

Representation letters can be used in all engagements — not just audits and reviews. CAMICO encourages practitioners to consider using representation letters for any engagement in which the accountant relies on significant management representations. These letters are often quite helpful to be certain owners and management take ownership for the representations being made in their financial statements. Their use when providing other services does not increase risk exposure by suggesting that a higher level of service and assurance is present. To avoid confusion, specify your level of service in both engagement and representation letters.

Obtaining your client's written representations is all the more significant when clients are facing an economic challenge. Representation letters are great defensive documentation, but they aren't a substitute for professional skepticism and judgment. Remember, just because you have a signed representation letter doesn't mean you can make like an ostrich and drill your head into the sand.

Be sure to reach out to CAMICO for guidance when your clients face "going concern" issues. These issues aren't limited to attest engagements. As always, CAMICO policyholders can call 1.800.652.1772 for assistance.

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