

Going concern

Not just a year-end conversation

Directors and management may have had substantive conversations this past year-end about the company's ability to remain a viable business. Even if management concluded it did not need to make going concern disclosures in its year-end reporting, the company isn't necessarily out of the woods. Why? Because by issuing financial statements, whether for an annual or quarterly period, management is asserting that the company is a going concern—unless it specifically discloses otherwise.

With the continuing deterioration of the economy through the first quarter of 2009, management needs to revisit going concern issues on a continual basis, especially if the company is on the brink of violating debt covenants or may soon need to refinance debt.

Debt covenants

Debt covenants typically are tied to income from continuing operations and key balance sheet ratios. As impairment charges reduce income and weaken the balance sheet, some otherwise healthy companies—even those with sufficient cash for operations and debt servicing—are finding themselves in actual or potential violation of debt covenants. Such companies are therefore in default or likely to default.

Banks once made a common practice of waiving debt covenants. Such waivers are no longer a given in today's beleaguered banking industry. Management needs to work with its bank either to obtain a waiver (which, as noted, is not guaranteed, and might involve significant fees) or to renegotiate its debt, possibly at less favorable terms. Although the added costs involved under either option are unappealing, management needs to address the issue if it expects covenant breaches over the next 12 months. Only after doing this can management assert that the company is a going concern.

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Companies that did not make going concern disclosures in their year-end financial reporting can't just call it a day: Going concern discussions may need to happen year-round, and not just at companies that are visibly struggling.

Counterparty risks

Counterparty risk is generally manageable, if a company pays attention. In the current environment, alert companies routinely reassess the economic and operational viability of their counterparties. So what should directors be looking for?

Fair value of nonfinancial assets and liabilities

Companies must now value certain nonfinancial assets and liabilities at fair value. How can audit committees oversee these complex valuation processes? Might there be lessons to learn from the use of fair value for financial assets and liabilities? It's worth a look.

Counterparty risks

What happens if key customers, suppliers, insurers, business partners, distributors, and other parties the company depends on no longer perform as expected?

One key lesson from the current economic environment is the importance of managing counterparty risk. What happens if key customers, suppliers, insurers, business partners, distributors, and other parties the company depends on no longer perform as expected? Any nonperformance could put significant pressure on the company. And so management needs to understand the likelihood and implications of key counterparties' failure to perform (or even to exist) and make sure the company is prepared to respond to that possibility.

Management faces tough challenges in analyzing the risks associated with counterparties. Among those challenges is the assessment of certain counterparties' financial and operating stability. For example, usually financial statements aren't readily available for private company counterparties or for subsidiaries of other companies that don't provide separate company financial information. This assessment is even more challenging if significant counterparties are halfway around the world, transacting business in a different culture and, perhaps, preparing their financial statements using a different basis of accounting.

As management focuses on counterparty risk, directors should be comfortable that management's monitoring program addresses

1. The implications of broader economic changes, such as new government regulations, or the tightening or loosening of credit
2. Regular reporting to the audit committee on management's analysis of the creditworthiness of the company's customers (the company should perform its own analysis and not rely exclusively on public ratings)
3. The risk of overdependence on one or more suppliers (e.g., as a result of a preferred-supplier arrangement) or customers, including the risk (and potential outcome) of more than one counterparty failing at the same time
4. The continued viability of the company's insurers, partners in derivative contracts, and sellers of credit default swaps, among other counterparties
5. Contingency planning for failure of one or more significant counterparties
6. Leveraging relationships with significant counterparties to identify risk

Counterparty risk is a known and largely manageable risk, and management can take steps to avoid costly surprises. Directors should assure themselves that counterparty risks are being realistically considered and management is addressing the risks appropriately.

Fair value of nonfinancial assets and liabilities

In 2008, a new approach to determining the fair value of financial assets and liabilities took effect. That approach has proved particularly challenging given the declining economy. In 2009, this approach is extending to fair value determinations of nonfinancial assets and liabilities—such as land, equipment, and certain payables (e.g., obligations under warranties) acquired in a business combination. What lessons were learned in measuring the fair value of financial assets and liabilities that can now be applied to nonfinancial assets and liabilities? How can audit committees be comfortable that the fair value measurements of significant nonfinancial assets and liabilities are being handled appropriately?

Because of the significant judgment required in the valuation of nonfinancial assets and liabilities, audit committee members should understand how management is controlling the valuation process and be assured that judgments are made by staff who have adequate and relevant experience, and that those judgments are appropriately reviewed. This is not an easy process for management or for the audit committee.

An added challenge is that fair value measures should be based on “orderly transactions” between market participants on the measurement date. Those transactions are assumed to take

place in the principal market (i.e., the one with the greatest volume of activity for the asset or liability). Often, however, a principal market for an individual nonfinancial asset or liability does not exist, making the fair value measurement more complex. In those instances, management has to consider all potential markets and choose the most advantageous one (i.e., in which the company would receive the highest price for the asset or pay the lowest amount to transfer the liability). Management must also base an asset’s value on its “highest and best use,” even if the company does not use the asset that way.

So, how can audit committees be comfortable that the fair value measurements of nonfinancial assets and liabilities are appropriate?

- For assets and liabilities that are individually significant (e.g., land and buildings; unearned property and casualty insurance premiums), understand management’s approach, assumptions, and other information considered in determining fair value.
- For assets and liabilities that are not individually significant but are significant as a group (e.g., furniture, equipment, and fixtures; equipment warranty obligations), understand the procedures for and controls around determining fair value.

- Be satisfied with the experience and education of the people making the fair value judgments, and understand the level of review and testing by management and by the internal and external auditors.
- Understand the financial statement implications of write-downs due to fair value adjustments. Also understand how the effect of those write-downs (e.g., on financial statement ratios and debt covenants) could introduce or exacerbate going concern risk.
- Consider how compensation and incentive structures could affect judgments management is making about fair values.

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Refinancing debt

If significant debt is maturing within the next 12 months or shortly thereafter and will not be paid off at maturity, management must be able to show that the debt will be refinanced at acceptable terms. The company's inability to refinance at acceptable terms could necessitate a going concern disclosure. As significant tranches of corporate debt become due between 2010 and 2012—some of it written under “easier” credit terms—refinancing may jeopardize the financial position of some companies.

The bottom line is that directors will continue to have boardroom conversations about the need for going concern disclosures. These discussions won't be happening just at year-end, and they won't be happening only at companies with dire earnings or pressing cash flow challenges. The new credit environment means such discussions may need to happen even if boards haven't expected them.

How PwC can help

To have a deeper discussion about how these subjects might affect your business, please contact:

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You may also want to read

2009 Current Developments for Directors – This annual publication captures important developments and the critical governance issues directors and executives face. The 2009 edition addresses key business issues such as the implications of the economic crisis, trends in governance, and key financial reporting developments (e.g., around business combinations and fair value accounting).

2008 Year-end Questions Audit Committees Should Be Asking – This January 2009 publication presents questions (with explanatory commentary) that audit committees should consider asking management and the auditors in light of the challenging economic conditions.

These and our other corporate governance publications are available at www.pwc.com/uscorporategovernance.

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