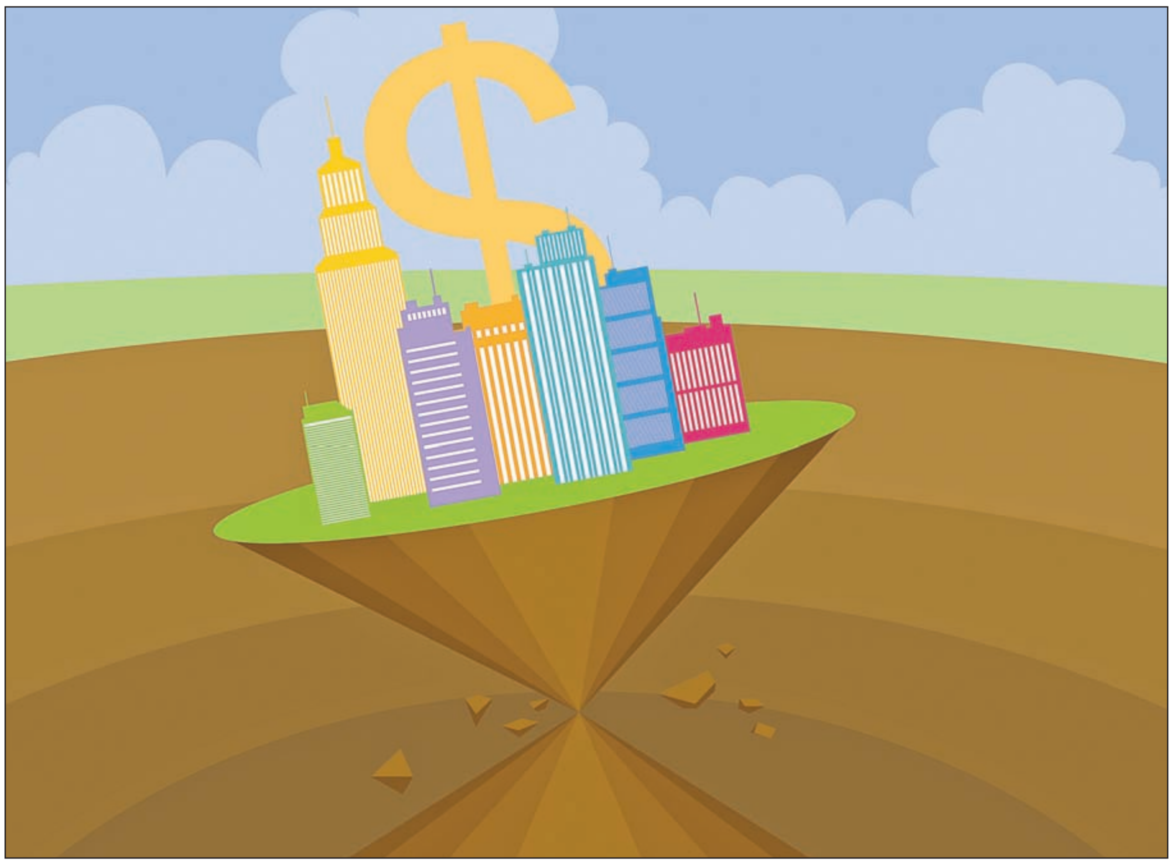
Drop in going concerns reflects slow recovery: Report

By GUNDI JEFFREY

A 13-year analysis of going concerns noted in the audit reports for financial statements filed with the U.S. Securities and Exchange Commission found that 2008 — when the global economy collapsed — produced the highest number of going concerns during the last 12 years.

The years before and after 2008 had almost as many, but there has been a steady decline ever since. According to the report's authors, the decrease gives the wrong impression of what is actually going on.



"An initial review of the data seemed to provide positive news," says Don Whalen, general counsel and director of research of Massachusetts-based Audit Analytics, which compiles audit, regulatory and disclosure intelligence. "But a deeper analysis found reasons for pause.

"The initial results appear positive because they show a drop in both the number and percentage of going concerns. Further analysis, however, reveals that this decrease is due to company attrition from the prior year's going-concern population — companies that disclosed a going concern for fiscal year 2011 and then chose to file a termination with the SEC."

Brad Owen, audit professional practice partner with KPMG, says he is not surprised with the numbers in the Audit Analytics report. "Anecdotally, we have found that a going concern note in the financial statements is an important juncture in a company's history," said Owen. "In our experience, ultimately, over the long term about one-third of the companies having them survive on their own, and two-thirds don't survive and are either taken over by others or disappear."

The report, released in mid-October, found that since fiscal 2008's 3,352 going concerns, the highest number during the last 13 years, there have been four years of consecutive declines. The estimated 2,517 going concerns to be filed for fiscal year 2012 is a decrease of 127 from the year before. The drop is not due to improved company performance, but company attrition from the prior year's going-concern population.

According to Whalen, "an analysis of the 2,644 companies that filed a going concern in 2011 showed that 228 of these companies filed a termination of registration with the SEC. Therefore, terminations alone would create a 228 drop, while the expected drop is only 127."

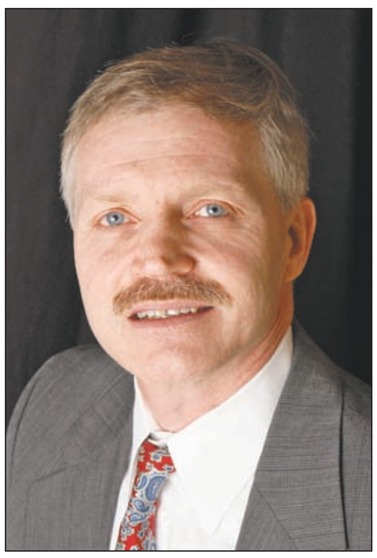
Audit Analytics estimated that 17.5 per cent of auditor opinions filed for fiscal 2012 will contain a qualification on the company's ability to continue as a going concern. During the 13 years under review, the highest such percentage, 21.1 percent, occurred in 2008 and the lowest, 14.1 per cent, came in 2000.

"The last five years — starting with 2008's 21.1 per cent, followed by 19.9 per cent, 19 per cent, 17.7 per cent, and 17.5 per cent in 2012, represent the worst percentages under review," Whalen said.

New going concerns — filed for this year, but not the prior year — are estimated to be 543, a low number compared to most years but higher than in 2011, at 518 new going concerns. Whalen notes that "the figure of 543 is low compared to most years — a good thing — but still an increase from the year before. An increase in new going concerns would be a positive indicator if it was due to new IPOs, but a review showed a going concern decrease in IPO forms."

According to Whalen, "fiscal year 2012 saw the fewest number of companies that improved well enough to shed their going concern status." A multi-year analysis of the going concerns identified companies that filed a going concern one year but not the following year. This could happen for two reasons: the company files a subsequent clean audit opinion, or the company fails to file audit opinions altogether, probably because it went private or ceased operating.

"A review of companies that experienced a subsequent improvement reveals that only 140 companies that filed a going concern in 2011 were able to file a clean audit opinion in 2012. This figure was surprisingly low," said Whalen, "and represented by far the lowest number of companies able to shed their precarious status in all the years analyzed."



WHALEN

To Whalen's surprise, given Canada appeared to suffer less from the global meltdown than the U.S., Canadian SEC filers showed almost the same profile as the overall population studied.

"The Canadian numbers are totally consistent with the overall numbers and would support exactly the same conclusions. I was expecting something different, but their overall numbers are roughly 10 per cent of the U.S., reflecting, to some extent, the difference in the number of SEC registrants between the two countries."

He noted there is a significant difference in the actual number of going concerns for Canadian companies. He expects about 53.9 per cent of Canadian auditor opinions on fiscal 2012 financial statements to contain a qualification on the company's ability to continue as a going concern. During the 13 years reviewed, the highest percentage, 57 per cent, occurred in 2008, and the lowest, 35.3 per cent, in 2002.

He explained these startling numbers by noting that half of the Canadian filers are mining and resource companies — 129 of the 260 Canadian companies that filed going concerns with the SEC in 2012. Mining companies often have going concern problems, Whalen said.

"There are simply too many unknowns in this business, too many risks. You start out by digging a hole but have no idea what you will find and how much of it. This makes auditors nervous."

He added that the prices of these natural resources are often very volatile. "The price can drop 30 per cent in one day. So, these companies can be profitable one day and shut their doors the next. Hence the large number of going concerns in this population."

Owen agreed. "The reality of the Canadian capital market is that it has a large proportion of junior resource companies. They live and die by the price of their commodities."

He notes as well that these companies are struggling to get financing. "They are seeing restraints on their ability to raise capital," said Owen. "Usually, they would be able to secure financing for their cash requirements for 12-18 months forward, but now they are lucky to secure financing for six to eight months forward. As a result, we are seeing a spike in the number of full-blown going-concern notes or a renewed focus on liquidity risk disclosure in the financial statements of resource companies."

Apart from that, Canada's results mirror the overall results of Whalen's study. And it seems odd that now, when the economy is finally improving, there are actually more going concerns than one would expect. Whalen believes it is because "the recovery has been very slow and prolonged. And Europe's difficulties have an impact here as well. Companies can weather the storm for a few years but, at some point, they may have to give up. The recovery has been so long and so slow that it is wearing certain sectors down."

CONTENTS