

A Lender's Guide To Going-Concern Qualifications

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In connection with an audit of the financial statements prepared by a borrower's independent public accountant or auditor, the auditor is required to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern in the future, typically one year from the date the relevant financial statements are issued.[1]

In considering whether a borrower is likely to be able to continue as a going concern within the relevant 12-month period, the auditor will consider various factors. Factors that may support a borrower's going-concern qualification include:

- Significant operational losses and working capital deficiencies;
- Termination of one or more material customer or vendor relationships;
- An adverse regulatory decision or litigation judgment; and
- The inability to comply with loan documents, including an expected inability to service debt or refinance an upcoming maturity.[2]

The auditor may also consider management's plans for dealing with adverse facts and conditions, including access to capital, pending mergers and acquisitions transactions, and plans to reduce or delay expenditures.[3]

With companies fighting a two-front war against rising interest rates and inflationary pressures, going-concern qualifications will be ever more topical and more frequent. Bed Bath & Beyond Inc. is just one of many recent examples of high-profile companies issuing going-concern qualifications due to financial distress.[4]

From the perspective of a secured lender, a going-concern qualification is a major red flag and may portend an upcoming restructuring or some other alternative transaction, such as one or more asset sales, merger or wind-down of the business and liquidation of assets.[5] Yet, timing is everything.

Even if a borrower delivers audited financials with a going-concern qualification, it may have a long



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liquidity runway and no other restructuring triggers, anticipated defaults or events of default that would otherwise incentivize a borrower to negotiate appropriate relief in exchange for providing the secured lender with downside protections.[6]

Further, existing equity holders and the board may pursue a high-risk, high-reward business strategy that maximizes equity optionality but increases risks to the borrower and its other stakeholders in a downside scenario.

Thus, it is extremely important for a secured lender to understand the implications of a going-concern qualification under the applicable loan agreements and for the borrower more generally.

As set forth below, a going-concern qualification in audited financials may or may not result in an event of default.

Audited Financial Reports Affirmative Covenant

A loan agreement usually requires that the borrower deliver audited financials within 90 to 120 days and that such audited financials do not include a qualified opinion with respect to borrower's ability to continue as a going concern.

The following is an example of a typical audited financial statements reporting covenant:

Annual Financial Statements

As soon as available and in any event on or before the date that is 90 days after the end of each Fiscal Year, the consolidated balance sheet of the borrower and its consolidated Subsidiaries as at the end of such Fiscal Year, and the related consolidated statements of operations and cash flows for such Fiscal Year, setting forth comparative consolidated figures for the preceding Fiscal Year, all in reasonable detail and prepared in accordance with GAAP in all material respects and, in each case, except with respect to any such reconciliation, certified by independent certified public accountants of recognized national standing whose opinion shall not be qualified as to the scope of audit or as to the status of the borrower and its consolidated Subsidiaries as a going concern (other than any exception or qualification that is a result of (x) a current maturity date of any Indebtedness or (y) any actual or prospective default of a financial maintenance covenant (including the ABL Financial Covenant)), all of which shall be (i) certified by an Authorized Officer of the borrower as fairly presenting in all material respects the financial condition, results of operations and cash flows of the borrower and its consolidated Subsidiaries (or Holdings or an indirect parent of the borrower and its consolidated Subsidiaries, as the case may be) in accordance with GAAP in all material respects and (ii) accompanied by a Narrative Report with respect thereto.

The above example includes going-concern qualification carveouts for debt maturities and anticipated breaches of financial covenants, which are common in market loan agreements.

It is also increasingly common for such provision to carve out a going-concern qualification arising from the activities, operations, financial results, assets or liabilities of unrestricted subsidiaries.

These carveouts underscore the importance of reviewing the financial reporting covenant closely and ensuring one understands the actual scope of any clean audit requirements, particularly in an era of covenant lite credit facilities where a breach of the covenant may be the only means of getting a

borrower to the negotiating table.

Delay in Delivery of Audited Financials

If a borrower is having trouble obtaining an unqualified opinion from its auditor, it may delay delivery of its audited financials until it can obtain such unqualified opinion, or otherwise buy time in anticipation of an event of default arising from delivery of the audited financials with a going-concern qualification once the audited financials are delivered.

Thus, it is also important to review the events of default in the loan documents to determine whether failure to deliver audited financials by the specified deadline is an immediate event of default, or whether it is instead a default that does not become a default unless it remains uncured after a specified period of time, usually 30 days.

Change of Fiscal Year

Part and parcel with the requirement to deliver unqualified audited financials is the timing of the borrower's fiscal year.

While many fiscal years overlap with the calendar year, some do not. Most importantly, the loan documents often allow the borrower to change its fiscal year.

Sometimes borrowers change their fiscal year to delay the delivery of their audited financials in anticipation of being unable to deliver a clean audit.

Some loan documents require the borrower to obtain the consent of required lenders to change the fiscal year, while others only require the consent of the agent, or may not require any consent or may only require notice of such change.

Additional Considerations

A going-concern qualification may exacerbate the financial distress of a borrower by, among other things, reducing the borrower's creditworthiness and ability to raise capital, increasing regulatory scrutiny and causing a deterioration of vendor and customer support.

However, it may also force a borrower to engage with its lenders sooner than it might otherwise have been inclined to, especially if it is expected to or does result in an event of default under the operative loan documents — particularly when no other default or event of default has occurred or is otherwise anticipated to occur.

Accordingly, it is very important for secured lenders to be aware of a going-concern qualification in a borrower's audited financials and consider the potential implications for the borrower and other stakeholders in connection therewith.

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[1] PCAOB AS 2415: Consideration of an Entity's Ability to Continue as a Going Concern, available at <https://pcaobus.org/Standards/Auditing/Pages/AS2415.aspx> (last accessed Feb. 21, 2023).

[2] Id.

[3] Id.

[4] The de-SPAC boom has been a fertile source of "going concern" qualifications. According to one study, 45% of De-SPAC companies issued "going concern" qualifications. See Adrienna Huffman, et al., *Going-Concern Qualifications: A Reliable Predictor of Insolvency?*, *ABI Journal* (Feb. 2023), available at <https://www.abi.org/abi-journal/going-concern-qualifications-a-reliable-predictor-of-insolvency>; see also Eliot Brown, *SPACs Are Warning They May Go Bust*, *Wall St. J.* (May 27, 2022), available at <https://www.wsj.com/articles/spacs-are-warning-they-may-go-bust-11653601111>; *Bed, Bath & Beyond Inc.*, Form 10-Q for Quarter Ended Sept. 30, 2022, at 9, 34, 37, available at <https://www.sec.gov/Archives/edgar/data/886158/000088615823000026/bbby-20221126.htm> (discussing why there is substantial doubt that the company can continue as a going concern for the next 12 months).

[5] While certain academic research indicates that going-concern qualifications have not been a good predictor of bankruptcy, the results may be skewed by not counting out-of-court restructuring and other nonpublic workouts in the data. See Huffman, et al., *supra* n.4.

[6] Examples of such downside protections include sale/refinancing milestones, increased financial reporting, and tightening negative covenants.