M Capital Corp. – Going Concern Qualification, Part 1

Overview – This case presents a situation where M Capital Corp. is disputing their auditor's claim that a going concern qualification is needed to their opinion on the company's soon-to-be-issued financial statements. If the qualification is issued it will significantly affect the company's ability to raise much-needed capital at a reasonable cost.

M Capital Corp started its development as a FinTech company in the services side of the business along with entrepreneurs in the communications industry. Their first acquisition was that of a small call center operation that served as a means of servicing FinTech companies that needed service follow up advice and support as well as back office administrative services. Operations were carried out through a number of call centers in Canada and in the USA.

The second acquisition was the acquisition of a messaging platform which was acquired using a share for share exchange at fair market value, which added to the capital of the corporation and raised its profile amongst the FinTech companies by being able to provide messaging services via SMS and other means at lower rates than even the telcos were willing to provide. This business grew rapidly because of its unique position in the market providing cash flow and profitability to the venture.

The third step was to initiate a consumer financing arm to the business. The call centers and messaging businesses had introduced the company to much larger corporations as a complimentary service provider and opened up the opportunity to start a financial services arm of the business through the prudent acquisition of a number of portfolios of loans that could be easily managed by the technical staff operating the call/service centers.

As an over-the-counter public company, M Capital Corp. was now growing to a size that it could attract an equity infusion from angel investors and could raise financing from the venture capital arms of major institutions. As a condition of the equity raise, the company applied for and was granted a listing on a Canadian venture exchange, and the attraction of the company grew. Negotiation for financial institution equity and debt financings became a crucial part of the Company's development.

Two opportunities presented themselves. The first was the acquisition of a $90 million dollar portfolio of loans through the acquisition of a subsidiary of a public corporation that no longer wanted to develop its consumer portfolio, and the second was a greatly enhanced but struggling call center business that could be easily acquired for a low cash payment and an extended earnout. This latter acquisition, although difficult because of its operational issues fit within the cash resources of the Company but the large portfolio of loans was a different matter and required a complete refinancing of the loan portfolios.

Two major financial institutions responded to the request for proposals. The portfolios were reasonably mature and had contracts that ran in age from 3 to 10 years of remaining duration. The portfolios were growing rapidly and provided a great base for the lenders. The financing offered was a fixed sum for the existing portfolio with a 7-year amortization, and a 7-to-8-year amortization of all new 10-year loans to be booked. The financial institution would provide an up-front payment equivalent to 115% of the face value of the loans but would require 100% of all cash flow from the loans until the advances were repaid. A hold back against potential bad debts of 10 % was required. This cash reserve would be held back from the original draw on the loans at the rate of 5% but would be required to grow to 10% from cash flows, permitting only a 10% net positive cashflow at the commencement of the portfolio and extending the term of the loan. The cash reserve declined over the term of the portfolio and could be withdrawn upon request as long as the 10% reserve requirement was being maintained. Defaults could temporarily be charged against the reserve and if the loans were brought current they could be removed as a charge against the reserve. Excess cash reserves could be withdrawn every 90 days after a reassessment of the reserve requirement.

Financial projections, based upon portfolio growth being experienced and the historical rates of default, showed that the cash flows from operation would be sufficient to maintain operational liquidity. Default rates were remaining within the expected ranges and the business was apparently continuing as projected.

Loans continued to be approved and advances made under the agreements for the ensuring year and the goodwill paid on the purchase price as allocated to the customer relationships that were originating the loans and to the apparent excess yield from the portfolio. Income was recognized on the accrual basis and costs of the acquisition were expensed in accordance with GAAP.

The call center acquisition was not experiencing the same good fortune. Service contracts had been negotiated for fixed terms at what appeared to be more that advantageous rates, but were not realizing the volumes required to make the rates per call profitable. The infrastructure costs were prohibitive based upon volumes, and the contracts had been negotiated based upon estimated volumes not guaranteed minimum volumes. In some cases, customers had their own call centers and the work was to be shared between internal services and the outsourced services, but there was no contractual split or guarantees.

Minimum wages were raised by the Government. The effects on the businesses were devastating. The call center work shrank further as the customers directed more of the work internally, being under no obligation to do otherwise. In addition, the customers refused to raise the hourly wage rate in the service contracts because the contracts had fixed rates for 2 more years with no obligation to agree to revise the rates. The customers raised the wages of their own employees causing a wage disparity between the outside call centers and their own call center services. While the call centers were paying more than minimum wages, the 25% jump in minimum wages resulted in a wage cost push that could not be sustained.

The integration of the call center activities into the finance side of the business had not been a priority for the call center management, as it was a service function and a collection function that they were not inclined to promote.

On the financing side, certain management, unknown to the senior executives, made some operational decisions. Loans that had stopped paying were immediately repurchased back from the financial institutions at their full payout price. Cash reserves were left intact to support the financial institutions and not managed in accordance with the financing agreement.

An immediate review of delinquency rates, their causes, and immediate follow up, was not implemented for several months. When the situation was discovered, it was determined that certain major sources of contracts were the cause of 90% of the defaulting contracts. Unfortunately, the loan origination group had based their recovery process for inappropriate contracts on the margins to be earned on the next group of contracts generated from the same suppliers. Once the chargebacks started to occur, these contract suppliers started to take their profitable business to other funders and refused to honour the buy-back arrangements.

The financial institutions refused to discuss any changes to their funding arrangements as presently operating. They refused to recognize the contract default process and rehabilitation arrangements in their original agreements and insisted that all contracts that had defaulted on any payments be repurchased and not presented again for refinancing once the default had been cleared. As a new condition, all new contracts being presented for financing had to have at least a 90-day compliance period before being presented as additions to the loan portfolio security.

The results of these changes meant that the cash flows of the Company were severely altered as to timing of advances and amounts of advances.

As a result of these matters, the Company was losing money, was running short of cash to continue its rate of expansion and had lost some of its prime sources of contract generations.

The Company immediately took the position that the earnout contract for the call center operations was in default, and would not be honored. The goodwill under the contract and the allocations to contractual arrangements were written off. The effect was a significant charge against shareholders' equity. Shareholders' equity was further reduced by the cancellation of the shares that were held in escrow during the warrantee period. Despite these losses, and the recording of losses from operations of this division the company's cash flows remained adequate and net equity remained well above the covenant level of $35 million.

The next blow to hit the company was the situation in the finance division. Loan buy backs were now an issue and to continue to expand there was a requirement for more financing. A good portion of the portfolio was now 4 to 6 years into their contracts, so the once the 7.5-year time span was reached, the balance of the free cash flows from the contracts, which was estimated to be in the range of $50 million would start to flow to the company and liquidity would be guaranteed over the ensuing 5 years.

The options available to the company are as follows:

1. Arrange financing with another financial institution based upon the free cash flow of $50 million. This financing would have to ensure that the original financier remains in first position.
    a. The question is: Can this financing be arranged? There have never been issues in the past.
    b. What is the probability that this can be done?
    c. Will the original financier allow it?
    d. Will the original financier finally relent, and do it?
    e. At what cost?
2. The Board of directors has also decided to sell the SMS messaging service unit which is part of the mobile service division. The Board has engaged a merchant bank of outstanding reputation. The SMS unit was unencumbered by any corporate indebtedness and has a fair market value based on EBITDA of $6 million, of a total value (at approx. 5 times EBITDA) from $22 million to $35 million. Sales documents have been prepared, and 3 bidders are in final stages of due diligence.
3. The company is negotiating a $10 million line of credit with a Schedule A Bank. A draft term sheet has been prepared and is in the process of being negotiated. According to both the Bank

representatives and the corporate executives, the probability of a successful completion of the financing is high but it still needs final Credit Department Approval.

Based on their assessment of the facts presented, the management of M Capital Corp. have concluded that adequate prospects existed to enable the company to continue as a going concern. The auditor, however, has been pressing for the company to accept a qualified opinion as a Going Concern.

Question:

1. Given the facts, and knowing that none of the financing transactions can be ultimately consummated before the audit report needs to be signed, should management accept the qualified opinion which would affect the company's ability to be financed, and/or the cost of the financing? Provide your reasoning for your conclusion.
2. If the auditor cannot be convinced that they are too skeptical of M. Capital Corp's viability, what else might be motivating the auditor's view?

Source: Professional Skepticism Case Collection for Professional Accountants, University of Toronto Professional Accounting Centre, 2023, PAC website https://www.utm.utoronto.ca/pac/case-collections/enhancing-professional-skepticism-case-collection.