M Capital Corp. – Going Concern Qualification, Part 2

Overview – After the discussion of the issues noted in Part 1 of M. Capital Corp., over the objections of management, the Auditors insisted on issuing a qualified audit report with respect to "Going Concern" issues. However, the situation was reversed during the next fiscal period and a debate ensued with management wanting a qualified report for "Going Concern" issues, but the auditors did not. The relevant developments during the next fiscal period are summarized below.

After the discussions between the management and auditors related to Part 1 of M Capital Corp. case, the auditors insisted upon a qualified audit report with respect to "Going Concern" issues. Months later, the following circumstances have occurred and there is a need to consider whether the Going Concern qualification needs to be maintained.

The initial attempts at financing of the excess security have not been consummated. The financial institution has not agreed to an inter-lender agreement that would permit access to the excess security. The Treasurer of the corporation has agreed with their stance and is no longer enthusiastically negotiating for the additional funding on the excess security.

However, the SMS division has been sold for $30 million and the deal has closed. The cash is in the bank and the company has recorded a gain on the disposal of the division of $25 million. The net equity of the company has been restored significantly and there is no risk of financing covenants being breached.

The auditors have completed their work for the year-end and are within days of finalizing their unqualified opinion when the following uncertainties arise:

1. Covid 19 becomes a pandemic and a shutdown is ordered.
2. Employees of the company are required to work from home, but this is not an issue with the company's technology.
3. Suppliers of products that are being financed are considered essential services so the flow of new contracts, at a reduced rate, seems to be reasonably assured.
4. The probability that customers of the finance division may be unemployed and unable to honor their payment obligations, although no evidence that his is happening has materialized to date.
5. No government support programs have been announced to date but there have been rumors that such programs are in the works.
6. Death rates are climbing as a result of the virus and many countries are on the verge of shutting down.

Management is concerned that it cannot see far enough ahead to know what is in store for the company. If delinquencies rise rapidly, the demand for cash will escalate. If people are unemployed and/or discontinue using the essential services, will loan originations stop with the result that the financing formula will no longer be viable. Will the volume of business decline to the extent that there will be insufficient cash to do both originations and cover operating costs? Will the profitability of the corporation suffer during the pandemic?

Questions:

1. Is the uncertainty of continued operations so great that the auditors should not remove the qualification from the audit report? Provide the reasoning for your decision.
2. What should management do?
3. What should the auditors do in response?
4. Was this a case of runaway skepticism?

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.