

Information Requirement of Going Concern Presumption

- Maintaining Sound Basis of Financial Reporting In a Volatile Financial Ecosystem

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Technical Director
Financial Accounting Standards Board
Submitted via Email to director@fasb.org
Re: File Reference 2013-300

I commend the Financial Accounting Standards Board (FASB) for its tremendous efforts on Exposure Draft (ED) of the Proposed Accounting Standards Update on Going Concern (GC) Presumption. I also appreciate the opportunity to comment on the ED.

While I strongly support FASB's effort to include guidance on management disclosure of GC uncertainty in US generally accepted accounting principles (GAAP), I do not believe the current binary and narrative GC reporting model is capable of conveying the incremental risk information on GC uncertainty required for maintaining GC presumption as basis of financial reporting in an inherently volatile financial ecosystem. To this end, I suggest that a particular form of rated disclosure of GC uncertainty called going concern rating (GCR) be incorporated in financial reporting so as to convey the information critically needed for maintaining GC presumption as basis of financial reporting. While GCR is conceptually designed as a multidimensional analytical tool to resolve several significant capital market issues, one of the dimensions – implied probability of insolvency - is briefly discussed in the context of disclosure of GC uncertainty in this comment letter.

As an important accounting postulate, GC presumption historically provided the justification for assets and liabilities to be valued in historical costs and held the dividing line between GC valuation and liquidation valuation. However, the current financial ecosystem has severely eroded, if not subverted, GC presumption as basis of financial accounting. The financial crisis in 2008 vividly demonstrated that companies can suddenly collapse (from going concern to gone concern in a matter of few days) without any early warnings or incremental risk information on GC uncertainty. In addition, mark to market valuation under severe circumstances is essentially liquidation valuation on GC basis, and going concern value can be "extracted" in zone of insolvency (also on GC basis) by credit default swap (CDS), which is functionally a cash flow arbitrage of going concern value by monetizing the economic benefits of debts which is decoupled from the legal rights of debts.

Originated as a legal concept in insolvency litigations in England during the 17th century, GC presumption is still widely used or embedded in present day's valuation practices, such as perpetual GC presumption in terminal value of discounted cash flow (DCF) valuation, in addition to being basis of financial reporting. In fact, GC is a concept more argued between lawyers and judges in bankruptcy courts than debated among accounting professionals, and is a subject more researched in

legal literature than accounting literature. As such, GC is as much a legal concept as an accounting concept. Furthermore, as GC describes certain economic scenarios, it is also an economic concept.

Because of the multiplicity nature of the GC concept, it has been difficult to define GC presumption in accounting and auditing literatures without contradicting in some ways its applicability in insolvency resolutions and financial regulations. For example, in the absence of unified interpretations of the probability phrases used in defining GC, such as “more likely than not” (MLTN) or “substantial doubt” (SD), interpretation of GC threshold is subject to uncertainty and is not legally enforceable in insolvency resolution and regulatory supervision without often resorting to litigations.

How do we deal with the issue of information uncertainty vs. binary GC presumption in an inherently volatile financial ecosystem where companies can collapse suddenly without any early warnings? In the absence of continuous exchange of incremental risk information on sudden gradation of GC uncertainty, the binary trigger of GC presumption could activate either too early or too late. Hence, this raises the issue of information requirement for maintaining GC presumption as basis of financial reporting.

One common sense solution is to insert a “slope” (a grading or rating scale) between going concern and gone concern to replace the dichotomous “cliff” of binary trigger and convey incremental risk information from the entire spectrum of insolvency risk in a continuum (from going concern to going concern uncertainty to substantial doubt to liquidation). However, this is beyond the capability of the current binary, narrative GC reporting practice. In fact, instead of facilitating conveyance of incremental risk information in a continuum, the proposed footnote disclosure would result in GC uncertainty being disclosed in three separate locations and the two thresholds would break the information spectrum into three separate, discontinuous ranges.

My research¹ advocates that GC uncertainty be viewed as “multidimensional” insolvency risk and be rated as such so that incremental risk information on insolvency can be conveyed to investors in the form of ratings, which are easily understood and can be readily incorporated into investment decision-making processes. In addition, I briefly explored possible incorporation of GCR in financial reporting to meet the information requirement of GC presumption in one of my blogs, entitled “Would Going Concern Rating Resolve the Regulatory Impasse on Going Concern Assessment?”²

¹ Convergence of Audit and Credit Rating Practices: Going Concern Ratings (June 2011) *International Journal of Disclosure and Governance*, <http://www.palgrave-journals.com/jdg/journal/v8/n4/abs/jdg201115a.html>. Going Concern Rating and Economic Analysis of Insolvency Risk (October 2012) Monthly Newsletter, Global Association of Risk Professionals (GARP), <http://www.garp.org/risk-news-and-resources/2012/october/going-concern-rating-and-economic-analysis-of-insolvency-risk.aspx>.

² Would Going Concern Rating Resolve the Regulatory Impasse on Going Concern Assessment? (March 2012) <http://www.harrisonstone.com/going-concern-assessment/would-going-concern-rating-resolve-the-regulatory-impasse-on-going-concern-assessment/>.

Conceptually, GCR rates GC uncertainty by assessing the implied probability of insolvency (IPI) on a rating scale that is inserted between going concern and gone concern. Therefore, GCR eliminates the dichotomous threshold issue of the binary GC reporting model. IPI is calculated as the probability of going concern value (GCV) being reduced by volatilities to become less than liquidation value (LV) according to the following formula:

- $GCV - \text{volatilities} < LV$ (Valuation test),

Where volatilities are driven by uncertainties from the following three insolvency tests:

1. $\text{Asset value} < \text{Liability value}$ (Solvency Test)
2. $\text{Cash flow} < \text{Current obligations}$ (Liquidity Test)
3. Significant losses of capital (Capital Test)

GCR rates a company throughout its lifecycle (from going concern, going concern uncertainty, substantial doubt to liquidation) in a continuum. GCR rating scale is calibrated in probabilities of insolvency, which are then mapped to letter ratings. Insolvency risk is rated to Insolvency Point (IP), which is an economic scenario mapped to the SD threshold, which is assumed to be 80% probability for now. Calibration for the MLTN threshold is similarly assumed to be 50% probability for now. Rating mapping for MLTN and SD would complete subject to further statistical research. As uncertainties from balance sheet solvency, liquidity, risk capital and valuation are incorporated in calculation of IPI, GCR is effectively multidimensional measurement of insolvency risk.

As I believe that GC presumption cannot be adequately maintained as basis of financial reporting without timely exchange of incremental risk information on gradation of GC uncertainty, I recommend that FASB consider incorporating graded or rated disclosure of GC uncertainty in financial reporting so as to facilitate the information exchange required for maintaining GC presumption as basis of financial accounting in an inherently volatile financial ecosystem. To this end, I would be happy to make myself available for further discussion with FASB.

Once again, I appreciate the opportunity to comment on FASB's proposal on management disclosure of GC uncertainty, and please feel free to contact me at simonhu66@aol.com should there be any questions regarding my recommendation and the GCR concept.

Sincerely yours,

Simon Hu

Appendix: Answers to Questions for Respondents

- 1 I agree in general with the proposed two-dimensional definition: realizing assets (solvency test) and meeting obligations (liquidity test). However, the proposed evaluation of GC uncertainty is single dimensional, liquidity test only. Although FASB had considered the merits of solvency test, but eventually decided on the liquidity test approach, as explained in BC15 on page 25. I believe that GC presumption defined as two-dimensional but measured as single-dimensional would undoubtedly create significant information vacuum that would mislead investors and dilute the value of the proposed footnote disclosure.
- 2 Management should bear the primary responsibility for making disclosure of GC uncertainty. However, in pursuit of liability avoidance in the absence of legally defensible quantitative justifications, management disclosure of GC uncertainty could be “forced” and become commonplace information which would disrupt capital market, mislead investors and increase directors and management’s (D&O) exposure to litigations at the same time. In addition, fragmented disclosure of GC uncertainty in three separate locations subject to two different thresholds would not add clarity in disclosure of GC uncertainty and convey additional incremental risk information, although the proposed footnote disclosure would add a new static risk signal before the SD threshold.
- 3 In general, binary and narrative reporting of GC uncertainty in the current financial ecosystem does not convey any meaningful incremental risk information that is easy to understand and can be readily incorporated into investment decision-making process. Without introducing what investors truly need - quantitative analysis of GC uncertainty as early warning for significant volatility and insolvency - the proposed footnote disclosure would only further fragment and add redundancies in disclosure of GC uncertainty.
- 4 Management is inherently biased in its view regarding a company’s ability to continue as GC, which is fundamentally different from its view in any other financial disclosure, such as earning forecast. However, an independent third party could be retained by board of directors to work with management in evaluation of a company’s ability to continue as GC, similar to how credit risk is analyzed and disclosed via credit ratings.
- 5 Disclosure of material events that would likely give rise to GC uncertainty should be made in real time as they develop instead of fixed intervals.
- 6 Despite the inefficiency of narrative disclosure of GC uncertainty, the proposed footnote disclosure does provide a new static risk signal at the MLTN threshold before the SD threshold, although the risk signal would not convey any incremental risk information and would certainly lead to information redundancies.

- 7 No comment.
- 8 Narrative disclosure of GC uncertainty by management would very likely lead to significant litigation exposures because qualitative only disclosure without quantitative underpinnings would easily cause misinterpretation among different groups of financial statement users. Therefore, forward looking analysis in the current financial ecosystem without legally defensible quantitative justifications would likely render management, directors and auditors alike vulnerable to a new kind of catastrophic litigations which has not been seen before. Historically, only shareholders filed class action litigations related to financial reporting matters while creditors filed class action litigations related to bankruptcy. However, in the current financial ecosystem where creditors and shareholders are equally exposed to “non-contractual” credit risks, such as credit valuation adjustment (CVA) volatilities, widening of CDS spreads and migration of asset valuation from level II to level III, management disclosure of GC uncertainty without legally defensible quantitative justifications could lead to a new kind of hybrid class action litigations involving creditors seeking compensations for alleged misrepresentations in financial reporting (such as recent bondholder settlements for structured transactions) and shareholders suing for alleged wrongful disclosure of non-contractual credit risk, such as reversal of creditor seniority in principal conversion of contingent convertible bonds, that leads to significant decline in share price and dilution of share ownership.
- 9 Auditors’ litigation exposure would equally increase under the proposed footnote disclosure because they would have to express professional opinions on the forward-looking analyses that management performs in assessment of GC uncertainty, such as valuation uncertainty on complex financial assets.
- 10 Without legally defensible quantitative justifications for forward-looking assessment of GC uncertainty, potential costs of the proposed footnote disclosure may come in the forms of 1) significantly more damaging D&O and accounting related litigations, 2) market disruption caused by massive “forced” GC modifications during volatile market conditions, 3) commonplace disclosure of GC uncertainty would likely create information overdose for investors, 4) competitive disadvantage for the US capital market with higher cost of capital vis-à-vis foreign capital markets, and 5) competitive disadvantage for US companies in global capital markets where foreign issuers not subject to similar disclosure requirement would benefit from cheaper capital. Therefore, in the absence of rated disclosure of GC uncertainty that would provide legally defensible quantitative justifications to management disclosure, the costs would outweigh the benefits.

- 11 The two thresholds in the proposed footnote disclosure would artificially break the information spectrum into three separate, discontinuous parts: the good (going concern), the bad (going concern uncertainty) and the ugly (substantial doubt to continue as going concern), without conveying any incremental information on how good, how bad and how ugly. In addition, while threshold is necessary for the proposed footnote disclosure, the main difficulty in implementation is the lack of unified quantitative interpretation for the probability words and phrases used to define disclosure threshold and GC modification threshold. Without quantitative justifications, it would be impracticable for management to define what economic scenarios would constitute the MLTN and SD thresholds and legally defend its judgment, especially when management is deemed as naturally biased in its view regarding the company's ability to continue as GC.
- 12 While the intent of avoiding the bright-lined 12-month consideration period is well understood, 24 months may still be too long a period in terms of litigation exposures for management in an inherently volatile financial ecosystem. Credit rating outlooks subject to real-time surveillance usually do not go as far as 24 months.
- 13 Effective disclosure of GC uncertainty should be made without the mitigating effects of management remedy. The analysis of the mitigating effects of management plans would be best left to investors to conduct, given management inherent bias in evaluation of its own plans.
- 14 No comment.
- 15 No comment.
- 16 Please refer to all previous answers.
- 17 For the sake of simplicity and efficiency, disclosure of GC uncertainty should be centralized in one place only, either in MD&A, footnotes, audit report or going concern rating report, so as to ensure the integrity of disclosure.
- 18 I disagree with FASB's decision not to require non-SEC filers to be subject to the SD threshold, as this would create significant information vacuum for investors, especially for high-tech or startup companies.
- 19 No comment.