Case 25-5c

Going Concern

ABC Co. (ABC or the "Company") is a regional wireless telecommunications service provider serving approximately 100,000 wireless customers in small cities and rural areas covering parts of six states in the Upper Midwest United States. In addition to providing wireless service to subscribers (i.e., customers), the Company also sells cell phones. The Company has two operating segments: (1) retail sales of cell phones and (2) wireless services.

The Company is majority-owned by a publicly traded private equity investment firm (PEI). In 2020, the Company borrowed $50 million (the maximum under its credit facility) from a third-party bank lender.

The Company's fiscal year-end is December 31. Historical financial highlights, preliminary results from a draft of ABC's 2021 financial statements, and the Company's 2022 forecast are provided below. Management is planning to issue the 2021 financial statements by the end of April 2022, in accordance with the requirements of the bank debt.

Financial Highlights

(in 000s)	12/31/2022 Forecasted	12/31/2021 Preliminary	12/31/2020	12/31/2019
Revenues	$198,000	$180,000	$175,000	$170,000
Net loss	(13,700)	(25,400)	(71,901)	(49,208)
Cash provided by (used in) operations	10,800	(12,800)	(24,300)	(15,770)
Cash and cash equivalents	19,800	11,500	28,354	7,681
Accumulated deficit	(134,350)	(120,650)	(95,250)	(23,349)
Debt	(50,000)	(50,000)	(50,000)	0

Additional Facts

- Management has provided a cash flow forecast through April 2023. See the Appendix, "Management Forecasts (Scenario Tables)."
- The cash balance as of February 28, 2022, is $9.5 million.
- Management estimates that negative cash flows from operations will turn the corner this year, with positive monthly cash flows beginning in July 2022.
- The $50 million in debt outstanding has an interest rate of 5.0 percent, which is payable at the end of each quarter. The final interest payment is due on the date of maturity.
- Management is in discussions with investors and expects to raise $80 million in a Series B financing in June 2022.

Required:

1. **Step 1 evaluation:** What conditions and events, considered in the aggregate, indicate there could be substantial doubt about ABC's ability to continue as a going concern for a reasonable period (defined under ASC 205-40 as "within one year after the date that the financial statements are issued")? Consider each of the following scenarios:

    - ***Conditions and Events, Scenario 1:*** The Company is forecasting positive cash flows from operations for the first time in three years and positive ending cash of $30.4 million as of April 30, 2023. Management is optimistic that increasing consumer confidence and anticipated cell phone releases from the major manufacturers will allow the Company to increase revenue by 20 percent in the second half of the coming year, and that closer monitoring of costs can reduce expenses by approximately 5 percent during the same period. Historically, the Company's revenue growth rate has been approximately 3 percent per year, with expenses remaining stable. The Company's bank debt is due June 15, 2023, and there are no projected covenant violations before maturity.

    - ***Conditions and Events, Scenario 2:*** The Company is forecasting positive cash flows from operations for the first time in three years and positive ending cash of $24.4 million as of April 30, 2023. The Company received additional equity funding from PEI in the second half of 2021 to acquire a struggling competitor in its largest market at a bargain price. The acquired entity has very similar operations, which has allowed the Company to quickly integrate it and eliminate redundant costs. The acquired entity has increased ABC's total revenues by 20 percent through April 30, 2022, and has improved the Company's expense ratio. The Company's bank debt is due March 15, 2023. The Company has a capital commitment from PEI for a total of $180 million, of which $120 million has been drawn through April 30, 2022, including the draw for the 2021 acquisition. The Company may draw down on the capital commitment at its discretion without further approvals from PEI.

    - ***Conditions and Events, Scenario 3:*** The Company's cash flow forecast is consistent with Scenario 2 above; however, the Company has fully drawn the PEI capital commitment and has no remaining availability, and the Company's bank debt is due June 15, 2022. On April 15, 2022, the Company successfully refinances its bank debt with its existing lender on mutually agreeable terms, which results in the extension of the maturity date to June 15, 2024, and an increase in the interest rate from 5 percent to 8 percent.

    - ***Conditions and Events, Scenario 4:*** The Company's cash flow forecast is consistent with that of Scenario 2 above; however, the Company has no availability under the PEI capital commitment, and its debt is held by two lenders. On June 15, 2022, $15 million is due to Lender A and on June 15, 2024, the remaining debt is due to Lender B. The credit facility with Lender B has financial covenants, including a minimum cash balance requirement of $5 million. If compliance is not maintained, an event of default results and the lender has the right to demand full payment of all outstanding amounts immediately.

2. **Step 2 evaluation:** Considering the conditions or events that raise substantial doubt about ABC's ability to continue as a going concern, is it probable that management's plans can be effectively implemented and that the plans would mitigate the relevant conditions or events to alleviate substantial doubt? Consider each of the following scenarios:

    - ***Management's Plans, Scenario A — Capital Raise/Equity Offering:*** The Company is forecasting insufficient liquidity to sustain operations (refer to *Conditions and Events, Scenario 1A* in the Appendix). Management is in discussions with investors and expects to raise $80 million in a Series B financing in June 2022. The Company plans to issue convertible preferred stock via a private offering. The investors include parties that were involved in previous capital raises executed by the Company as well as potential new investors. Management is confident that the Company will be able to execute the capital raise based on its previous success with the Series A financing.

    - ***Management's Plans, Scenario B — Refinance or Amend Credit Facility:*** The Company is forecasting debt covenant violations under its credit facility and has debt coming due (refer to *Conditions and Events, Scenario 4* in the Appendix). Management is in discussions with the Company's existing lender to provide covenant relief and extend the maturity date of the credit facility. The Company has also initiated discussions with other lenders to explore a refinancing of the debt via a new credit facility. Management was successful in obtaining its credit facility in 2020 and worked with the lender in 2021 regarding several provisions, which resulted in two amendments. Management is optimistic that the Company will be able to amend the existing credit facility to revise the covenants and maturity date on mutually agreeable terms or to refinance with a different lender.

    - ***Management's Plans, Scenario C — Reduce or Delay Expenditures:*** The Company is forecasting insufficient liquidity to sustain operations (refer to *Conditions and Events, Scenario 1A* in the Appendix). The Company also has $15 million of debt coming due in March 2023. In response to the Company's projected cash requirements, management has begun to take steps to streamline and reduce selling, general, and administrative expense. As part of this process, management has identified two store locations that are redundant in certain areas of the Company's operations and two others that are underperforming. Management's plan is to terminate store leases and the associated headcount for some or all of these locations and to finalize and announce the plan internally after the December 31, 2021, financial statements are issued. The lease terminations and associated headcount reduction for all possible locations are expected to result in one-time termination fees of $2 million to break the leases and a monthly expense reduction of $1 million. As a result, beginning June 2022, the Company projects positive rather than negative cash flows from operations through April 2023.

    - ***Management's Plans, Scenario D — Parent Support Letter:*** The Company is forecasting insufficient liquidity to sustain operations (refer to *Conditions and Events, Scenario 1A* in the Appendix). The Company also has $15 million of debt coming due in April 2023. PEI has a 73 percent interest in the Company. PEI also holds a controlling interest in a number of other regional wireless telecommunications service providers and other technology-focused companies, as well as a diversified portfolio across multiple industries. PEI has reported the following results as of December 31, 2021, and December 31, 2020 (audited by a competitor firm):

(in 000s)	12/31/2021	12/31/2020
Revenue	$6,101,800	$7,330,000
Net income (loss)	2,610,000	3,810,000
Cash on hand	64,900	350,000
Working capital	4,302,000	3,754,000
Equity	14,520,000	15,015,000

PEI has indicated to ABC's management that it has a vested interest in the success of the Company and will provide a parent support letter to ABC indicating its intent and ability to financially support the Company for one year following the date that the financial statements are issued.