5-2020

Managing the Going Concern Risk in an Uncertain Environment An Analysis of Regulatory Guidance and Financial Relief for the COVID-19 Pandemic

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An Analysis of Regulatory Guidance and Financial Relief for the COVID-19 Pandemic

By Nicholas C. Lynch, Michael F. Lynch, and Charles P. Cullinan

In Brief

The worldwide COVID-19 pandemic has affected businesses of every size in every country, and the United States has been hit particularly hard. Many businesses are facing increasing doubts about their ability to continue as a going concern, and the decisions that surround that determination have an impact on both management and auditors. The authors provide an overview of FASB, PCAOB, and AICPA guidance regarding going concern issues, then discuss how these standards apply to federal programs designed to aid businesses during the pandemic, particularly those created by the CARES Act.

Currently, the United States is in the midst of the worldwide coronavirus (COVID-19) pandemic, which is stretching business and government resources alike. Representational faithfulness and transparency in financial reporting is essential to stakeholder decisions in this environment. The need for proper disclosure of financial condition is critical to the survival of the relevant financial accounting and reporting frameworks, as well as the audit profession.

The SEC recently acknowledged that in today's business climate, historical information may be significantly less relevant than before. The SEC is urging companies to provide robust, forward-looking discussions in earnings releases and investor and analyst calls regarding their operational and financial standings, management's COVID-19 response, and how operations and financial condition could change moving forward (Jay Clayton and William Hinman, "The Importance of Disclosure—For Investors, Markets, and Our Fight Against COVID-19," Apr. 8, 2020, https://bit.ly/3aUL3rH). All stakeholders would benefit from an update on the current state of going concern guidance in financial reporting and auditing for large, medium, and small business entities.

This article provides an in-depth analysis of going concern responsibilities for managers and auditors of public and nonpublic business entities in an effort to both synthesize and clarify similarities and differences in regulatory standards. It also discusses steps that managers can take to both evaluate and alleviate uncertainties to a level where the business can continue to operate as a going concern. It concludes with pertinent information for CPAs advising or auditing small business clients during the COVID-19 pandemic.

COVID-19's Impact on Business

That the economic fallout of the COVID-19 pandemic is disrupting business is undisputed. Companies in certain industries, such as travel and dining, are seeing drastic effects on financial results. For example, United Airlines reported in a recent Form 8-K that it expected daily revenues to be $100 million lower in March 2020 than March 2019. Similarly, the parent company of Chuck E. Cheese reported a 21.9% decline in same-stores sales in Q1 2020 versus Q1 2019, which it attributes to the closure of "on-premise dining, entertainment, and arcade rooms." Note that January and February results,

before COVID-19 caused widespread closures.

Even companies that remain operational have been affected financially by the pandemic. For example, manufacturing company Regal Beloit reports that it has drawn $255 million on its line of credit, even though it "has a strong balance sheet and does not currently intend to use the borrowed proceeds, but believes an abundance of caution regarding its cash position is prudent at this time."

A financial accounting report, regardless of an audit, reflects the assumption that the business entity will continue as a going concern until it is liquidated. An asset liquidation generally has a negative effect on all stakeholders, including investors, creditors, accountants, managers, and the government. Financial statements, including balance sheets and income statements, do not purport to convey the market or liquidation value of an entity; however, managers and auditors must assess and disclose any uncertainties regarding the continuity of business operations on an interim and annual basis. The purpose of such disclosure, in the notes that accompany the financial statements and in the audit opinion, is to both inform and warn stakeholders of the risks surrounding the ability of the entity to meet its obligations on an ongoing basis.

Now more than ever, there is heightened scrutiny around the ability of business entities to continue as a going concern. CPAs must ensure that they are following the proper audit guidance and that they are advising clients on how to assess, evaluate, plan for, and report any substantial doubts surrounding clients' ability to meet their obligations on an ongoing basis.

Management's Responsibility

The responsibility to prepare financial statements on a going concern basis under U.S. GAAP and the International Financial Reporting Standards (IFRS) falls on management. FASB provides guidance on when and how to disclose going concern uncertainties in Accounting Standards Update (ASU) 2014-15, *Presentation of Financial Statements—Going Concern: Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern,* codified in Accounting Standards Codification (ASC) 205-40. This covers all businesses that prepare GAAP-compliant financial reports, including those in compliance with the Private Company Council (PCC) alternative reporting framework.

Under the GAAP standard, management must assess the going concern of the business on an interim and annual basis. Managers must perform a forward-looking assessment based on relevant business conditions and events that are both known and reasonably knowable, that is, those that can be identified without an undue effort or cost on the part of management. Managers must look forward for a "reasonable period of time," defined as 12 months from the financial statement issue date or 12 months from the date financials would have been issued for entities that are neither SEC filers nor conduit bond obligors for debt securities that are traded in a public market. For government entities and those that follow the financial reporting framework for small or medium entities (SME), the reasonable period is 12 months from the financial statement date.

Under ASC 205-40, managers must disclose an uncertainty regarding the ability of the business to continue as a going concern if "substantial doubt" exists when the conditions and events described above, considered in aggregate, indicate that it is "probable" that the entity will be unable to meet obligations as they become due. Probable is defined by FASB as "likely to occur" under FASB ASC Topic 450, "Contingencies."

The timing of the COVID-19 pandemic, which came to the United States after the typical December 31 financial statement close, may heighten the difficulty of making substantial doubt judgments. In assessing the entity's ability to continue as a going concern, knowledge of the potential effects of COVID-19 can be considered a subsequent event.

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Although managers are not expected to predict the future, the definition of "substantial doubt" and the "probable" threshold play key roles in the assessment of the ability of the entity to meet its obligations. For example, at what point would it be likely that management has substantial doubt regarding the continuity of the business due to the COVID-19 pandemic? When the disease was first reported to exist in Wuhan, China? When it affected business operations in China? When cases started spreading globally? When it first began to negatively affect the business entity or suppliers? Or when it began substantially negatively affecting the business entity?

ASC 205-40 provides examples of conditions and events that may indicate an inability to meet obligations. These events are in line with those expressed in auditing guidance and include the following pertinent examples:

- Negative financial trends, including, but not limited to, operating losses that persist over time, deficiencies in working capital, and negative cash flows from operating activities
- Indications of financial difficulties, such as defaults on loans or other agreements, dividends in arrears, the denial of common trade credit from suppliers, debt restructuring in order to avoid default, a need to dispose of substantial assets, a need to seek new financing sources and methods, and noncompliance with capital requirements
- Internal matters, such as work stoppages or other labor difficulties, substantial dependence on the outcome of a project, unprofitable or unviable long-term commitments, and a need to significantly revise operations
- External matters, such as legal proceedings or legislation that may jeopardize the ability of the entity to operate; loss of a significant patent, license, or franchise; loss of a key customer or supplier; and an uninsured or underinsured catastrophe.

Managers must assess the above conditions and events alongside other current business factors, such as the financial condition of the entity, including available liquid funds and access to credit at the financial statement issue date; all of the entity's obligations that are due within one year of the issue date; and the funding necessary to maintain operations given current financial conditions, all entity obligations, and other expected cash flows within one year of the issue date. If the substantial doubt threshold is met, management must next determine whether such doubt can be alleviated by management's plans. In any case, a note disclosure must be included.

If substantial doubt is raised but is alleviated by management's plans, the note disclosure must include the principal conditions or events leading to substantial doubt, management's evaluation, and the plans that alleviate the substantial doubt, which should only be evaluated if they are approved prior to the financial statement issue date and if, as of that date—

- it is probable that the plans will be implemented within one year, and
- it is probable that once implemented, the plans will mitigate the substantial doubt surrounding the entity's ability to continue as a going concern within one year.

If substantial doubt is raised and is not alleviated by management's plans, the note disclosure must include the principal conditions or events leading to substantial doubt, management's evaluation, the plans that are intended to mitigate the substantial doubt, and a statement that there is "substantial doubt about the entity's ability to continue as a going concern," according to ASC 205-40.

Disclosures can change as conditions and events surrounding the substantial doubt change. If the substantial doubt continues or grows in subsequent periods, subsequent disclosures should reflect that reality. If the substantial doubt is alleviated or resolved, extensive disclosures should be made in the relevant period regarding how the substantial doubt was alleviated or resolved, regardless of whether the resolution had to do with management's plans.

PCAOB Auditor Responsibility

Issuer audits fall under PCAOB Auditing Standard (AS) 2415, *Consideration of an Entity's Ability to Continue as a Going Concern.* An auditor's initial assessment of substantial doubt regarding going concern is based on evidence the auditor has gathered through the opinion date; the auditor's assessment is based on "relevant conditions and events that exist at or have occurred prior to the date of the auditor's report" (AS 2415.02).

A timing difference exists between FASB and PCAOB guidance. The PCAOB auditor evaluation period is defined as "not to exceed one year beyond the date of the financial statements being audited." In other words, the auditor assessment period begins on the financial statement date, and not the *issuance date,* as in the FASB guidance. For example, if the balance sheet date is December 31 and the financials are issued on February 1, auditors must assess for no longer than one year from December 31, while managers must assess for 12 months from February 1. Managers must therefore assess for a potentially longer period than auditors. This provides for the inclusion of circumstances and events greater than one year past the balance sheet date, or the date that the financials are created. This periodic difference does not exist for government entities or SMEs, whose managers use the financial statement date rather than the issue date.

AS 2415 also does not use the probability threshold to define substantial doubt, unlike the GAAP definition. Rather, AS 2415.03 guides auditors on how to evaluate whether substantial doubt exists as to an entity's ability to continue as a going concern for a reasonable period of time. This evaluation includes the following:

- The auditor must identify conditions and events based on audit procedures that, in the aggregate, indicate substantial doubt surrounding a going concern assumption. This may involve obtaining additional information and evidential matter.
- If the auditor makes an initial assessment that substantial doubt exists, the auditor then will gather information about management's plans to alleviate the substantial doubt. The auditor must also assess the likelihood that management's plans can be effectively implemented.
- The auditor must then conclude, after evaluating management's plans, whether substantial doubt remains as to the entity's ability to continue as a going concern for a reasonable period of time.
- If substantial doubt still exists, the auditor should consider whether management's disclosures surrounding the going concern are adequate and include an explanatory paragraph in the audit opinion to reflect the auditor's conclusion. Proper audit documentation is necessary.
- If the auditor revises the assessment of substantial doubt in light of management's

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plans and believes that the initial doubt has been alleviated, the auditor should consider whether disclosure is necessary.

The PCAOB guidance also provides examples of conditions and events that may indicate an inability to meet obligations, which are essentially the same as those provided by FASB.

In considering management's plans to alleviate substantial doubt, auditors should consider the manner and feasibility of such plans. Management's plans generally involve planned asset disposals, plans to borrow money or restructure debt, plans to reduce or delay expenditures, or plans to increase ownership equity. The Coronavirus Aid, Relief, and Economic Security (CARES) Act, further discussed below, could be a factor to consider when assessing the feasibility of management's plans to deal with the substantial doubt of going concern, particularly regarding plans to obtain capital financing. Auditors should approach the use of prospective financial information in management's plans with professional skepticism and ensure that the information is consistent with historical trends and not overly susceptible to changes in the business environment.

If management's going concern disclosures are adequate, auditors should add an explanatory paragraph to the unqualified opinion drawing users' attention to the substantial doubt about the entity's ability to continue as a going concern (AS 2415.12). This paragraph will typically summarize the nature of the substantial doubt and reference management's note disclosures regarding going concern. Substantial doubt about an entity's ability to continue as a going concern is assessed independently in each period; thus, the presence of substantial doubt in one period does not necessarily imply that such doubt existed in previous periods, and the opinion on comparative financial statements from previous periods need not be modified. Conversely, if substantial doubt existed in previous periods and has been resolved by the date of the current auditor's report, the auditor does not need to mention the substantial doubt from previous periods. In the exceptional case that management's going concern disclosures are not adequate, this would represent a departure from GAAP that warrants a qualified or adverse audit opinion (AS 3105.24–25). The absence of a reference to substantial doubt in an audit opinion should not be taken as assurance of the entity's ability to continue to operate as a going concern.

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AICPA Auditor Responsibility

Auditors of nonissuers follow the guidance contained in AICPA AU-C section 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern,* which applies to all audits of a complete set of financial statements, regardless of whether the financials are prepared in accordance with a general purpose or a special purpose framework, such as the cash basis, tax basis, regulatory basis, or contractual basis. AU-C section 700A, *Forming an Opinion and Reporting on Financial Statements,* and section 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks,* define such frameworks.

AU-C section 570 directs auditors to consider whatever accounting framework the entity uses to assess substantial doubt, even if that framework does not include an explicit requirement for management to make a specific evaluation of a going concern assumption. For a client whose financial statements are prepared in accordance with GAAP, auditors should follow that framework and use guidance from either FASB or GASB.

Auditors must draw conclusions as to whether substantial doubt exists as to an entity's ability to meet its obligations over a reasonable period of time based on audit evidence obtained as a result of audit testing. They must also evaluate possible financial statement effects, as well as the adequacy of management's disclosures regarding any substantial doubt surrounding a going concern.

Auditors following AICPA guidance are called to perform an independent and objective evaluation of management's financial report and then come to their own conclusions on whether the use of the going concern basis is appropriate. They should ask whether managers have performed the required evaluation per their relative framework (FASB or GASB) or require them to perform an evaluation if their framework does not explicitly require them to do so. Auditors must then view, consider, and discuss that evaluation with management to determine whether it includes all relevant information that the auditors are aware of.

Auditors must evaluate management's plans to alleviate any substantial doubt, as well as any new information that has become available since management made its initial evaluation. They then must evaluate the adequacy and appropriateness of management's disclosures around the conditions and events relative to the going concern, then express the appropriate audit opinion (with an appropriate emphasis-of-matter paragraph, if necessary) and communicate the results with those charged with governing the entity.

The COVID-19 Response

The COVID-19 pandemic creates an environment of substantial doubt surrounding the continuity of many business entities. Certain industry sectors, such as hospitality, have been more affected than others. Small businesses such as restaurants, bars, hotels, and boat charters are especially susceptible to substantial doubts surrounding their ability to continue to as a going concern. Managers of small businesses, which employ approximately half of the workers in the private sector, are likely scrambling to remain up-to-date with constantly changing information concerning how to keep their businesses operational, rather than ensuring adequate evaluations of the going concern assumption. This section provides pertinent information for CPAs regarding advising or auditing their smaller, less complex business clients during and after the COVID-19 pandemic.

A smaller business may be able to respond quicker than a larger entity to adverse conditions, but may lack the necessary reserves to sustain operations. CPA advisors and auditors alike must be aware of the risk that banks and other lenders may not support an entity if it cannot meet its obligations. Losses of principal suppliers, major customers, or key employees are particular risks that must be assessed during the COVID-19 crisis.

In many cases, managers of smaller entities may not have prepared an evaluation of the circumstances and events that may raise substantial doubts, in aggregate, about their ability to meet their obligations for a reasonable period, especially if their framework does not explicitly require one. It is not the auditor's responsibility to rectify the lack of a management evaluation; however, there are instances in which auditors can draw a conclusion regarding substantial doubt without a detailed management analysis, such as if a history of profitable operations and access to financial resources exists. Auditors may rely on in-depth knowledge of the business and future prospects, but if the reporting framework calls for a detailed evaluation, then management should provide one.

Auditors must assess management's evaluation to ensure that all appropriate conditions and events have been considered and that a reasonable time period has been used. For smaller entities, it may be appropriate to focus on the financing obligations and options, as financial support from internal and external sources is often vital to a smaller business's ability to continue as a going concern. A business's financing options may be limited to funds from owners or managers, and should be assessed in light of existing debt obligations. For example, consider a restaurant that recently changed ownership whereby the new owner is paying off a loan to the old owner. In this case, the auditor should discuss with management the ability of the restaurant to continue to make loan payments, as well as scrutinize any collateral backing up the lending agreement, in light of how it will affect the owner's ability to personally fund operations; for instance, is the loan backed by personal assets, or is there a guarantor?

If substantial doubt exists, management must come up with plans to alleviate the probability of not meeting obligations, and auditors must consider those plans. This is a key process for managers, CPA advisors, and auditors. Inherent to management's plans should be an analysis of cash flow and profits, including forecasts. Managers and auditors alike should document the existence of any claims or other type of litigation in which the business is currently involved. There should also be an assessment of steps the business is taking, or plans to take, to continue to meet obligations as they become due. An analysis of financial support options can be documented in the form of a support letter or a written representation so that the auditor can assess the intent and ability to provide support. In the cited example above, is the old restaurant owner willing to temporarily suspend or restructure the lending agreement? Does the owner/manager have a personal cash reserve to fund operations, or can assets be liquidated to meet obligations? In the case of the COVID-19 pandemic, federal, state, and local governments are offering relief to business entities to help keep them operational. An evaluation of available relief and a documented plan of how to use such relief to meet the going concern assumption are essential to alleviating substantial doubt.

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COVID-19 Relief

Due to the COVID-19 crisis, federal, state, and local governments are releasing funds to help keep businesses afloat. The CARES Act includes funding that is available through a loan program with the Small Business Administration (SBA). The SBA website (http://www.sba.gov) provides links for numerous relief options, including the Paycheck Protection Program (PPP), the Economic Injury Disaster Loans (EIDL), SBA Express Bridge Loans, and SBA Debt Relief.

PPP loans. These loans exist first and foremost for hiring, rehiring, and retaining employees during the COVID-19 pandemic. Money that is used for payroll costs can be fully forgiven, while 25% of money used for other business expenses such as rent, mortgage interest, or utilities can be forgiven. Payroll costs include salaries, wages, cash tips, payments for regular leaves of absence, group health insurance payments, retirement benefits payments, and some state and local payroll taxes. Businesses must retain employees at comparable salary levels. The remainder of the loan is to be repaid over two years at an annual interest rate of 1%. Auditors will have a role in verifying the measurement of any amounts payable in subsequent years' financial statements.

The loans are available to small businesses, including sole proprietorships, in operation on February 15, 2020, with 500 or fewer employees, and can be up to $10 million. The program lasts from February 15 until June 30, or until the funds are depleted. The maximum loan size is equal to 250% of the employer's average monthly payroll cost. Eligible applicants include nonprofits, veterans' organizations, independent contractors, tribal concerns, and self-employed individuals. Applications are furnished online through a financial institution website, and loan money may be received within one day. No collateral or personal guarantee is needed, but the government will ask for documentation of payroll and other business expenses. The payroll portion of the loan is based on what employees were paid in the prior year. Borrowers are eligible for loan forgiveness equivalent to the sum spent on covered expenses during the eight-week period after the loan is originated.

Relief plans are changing daily, so business owners should be sure to keep up with current options by checking the SBA website as well as state and local government websites.

Business owners will need to document how many workers they employed and what they paid to them during that period, as that amount can be fully forgiven. Businesses that laid off workers have until June 30 to rehire them, and the amount of the loan that will be forgiven increases with the number of employees rehired. According to the SBA, businesses with more than 500 employees in certain industries can also apply.

PPP loans can pay for up to eight weeks of payroll costs, including benefits and other costs. While these loans can help keep employees hired and paid, they may not make sense for small businesses like restaurants or hotels, which simply do not have any work for these employees to perform.

EIDLs. These loans are also available through the SBA website and can be obtained alongside PPP loans. They are designed for businesses whose losses have left them with working capital deficiencies, and are designed to help them meet operating expenses. If the business obtains both a disaster loan and a PPP loan, however, the disaster loan cannot be used for payroll purposes. Disaster loans provide owners up to $2 million and can be repaid over terms as long as 30 years at 3.75% annually. Loan terms will be determined on a case-by-case basis. Small businesses can also apply for $10,000 loan advances that do not have to be repaid and can be granted within three days.

EIDLs could be part of management's plans to alleviate the substantial doubt about going concern. In this case, management would need to evaluate whether the loan is probable and whether it would alleviate the substantial doubt of going concern within one year. Auditors would also need to be aware of the availability and repayment requirements of these loans when assessing substantial doubt and the feasibility of management's plans to deal with the going concern issue. For example, management will need to be able to show the portion of a PPP loan that went to payroll versus other costs, and auditors will need to trace funds in order to verify their purpose.

Relief plans are changing daily, so business owners should be sure to keep up with current options by checking the SBA website as well as state and local government websites. Because the CARES Act has been enacted by legislation, is run by the Treasury Department, and involves the SBA, the application for relief is sufficient for auditors to discern management intent.

Main Street Lending Program

The Federal Reserve has expanded its Main Street Lending program, established under section 13(3) of the Federal Reserve Act, in an effort to provide COVID-19 relief to small and medium-sized businesses. The minimum loan size has been reduced to $500,000 (formerly $1 million) and the number of eligible borrowers has been expanded to include businesses with 2019 annual revenues of up to $5 billion or 15,000 employees (formerly $2.5 billion and 10,000 employees). This was done in an effort to include businesses that are either too large to benefit from SBA relief or too small to benefit from public equity issues.

Under the program, businesses can apply for below market rate loans at LIBOR plus 3% for periods of up to four years. Although the loans must be repaid, payments will be deferred for the first year. Loans may be used to refinance existing debt.

The Federal Reserve is offering three loan options: new, priority, and expanded. Options for new and expanded loans are for companies with lower levels of outstanding debt, and require banks to retain 5% of the debt. Priority loans are for companies with higher levels of outstanding debt, and require banks to retain 15% of the debt sold to the Federal Reserve. The minimum loan amount for new and priority loans is $500,000, while the minimum loan amount for an expanded loan option is $10 million. Maximum loan amounts for new and priority loans are the lesser of $25 million or an amount that, when added to outstanding and undrawn available debt, does not exceed four times the borrower's 2019 income, adjusted for interest, taxes, depreciation, and other adjustments (i.e., adjusted EBITDA) for new loans and six times 2019 adjusted EBITDA for priority loans. The maximum amount of an expanded loan is the lesser of $200 million, 35% of existing outstanding and undrawn available debt, or an amount that, when added to outstanding and undrawn available debt, does not exceed six times the borrower's 2019 adjusted EBITDA.

There are hurdles to the Main Street Lending program. For example, the loan must meet the highest available rating from financial regulators, a "pass" rating. Furthermore, there is no option for businesses that utilize asset-based lending, such as oil and gas companies. Businesses in this sector already carry high debt levels, and therefore may not be able to access these loans. Finally, businesses should pay close attention to dividend, compensation, and stock repurchase limits that last for 12 months after the loan has been repaid.

The COVID-19 pandemic has increased scrutiny of 12-month projections, so both managers and auditors need to be realistic and reasonable with their assumptions.

Finding a Way Forward

Although there are low-cost financing options available to business entities through the government, managers and auditors both must determine whether these or other available financing options, or other management plans, will alleviate substantial doubt for a 12-month period. The COVID-19 pandemic has increased scrutiny of 12-month projections, so both managers and auditors need to be realistic and reasonable with their assumptions. Managers might consider delaying the issuance of the financial statements until some of the uncertainty surrounding the pandemic has been resolved; however, they should consider the effects such a delay will have on their users, and how it might impact debt covenants or other aspects of the business. In other words, delaying the issuance of financial statements and note disclosures may be a risk in and of itself.

CPA advisors, auditors, managers, and other stakeholders should be familiar with the rules surrounding the disclosure of risks and uncertainties regarding an entity's perceived ability to continue as a going concern. Businesses are being challenged like never before to either adapt or perish. Stakeholders should expect to see increases in going concern disclosures, as well as in explanatory and emphasis-of-matter paragraphs in audit opinions regarding going concern issues. CPAs are well positioned to advise their clients during this time and provide higher quality information to stakeholders that use that information for vital business decisions. ❑

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