CHAPTER 13

2020 YEAR ENDING COVID-19 REPORTING

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I. <u>"GOING CONCERN" ASSUMPTION ISSUES</u>

Auditor reporting about our client's entity's financial condition is information critical to our turbulent economy and international security exchange markets. Amid the economic turmoil related to the coronavirus pandemic, the SAS 132 going concern assumption application and disclosure is one of the auditor's most frequent 2020 year-end questions. The information herein does not address audits performed in accordance with SEC and PCAOB standards.

A. <u>Management Assertion</u>

Management is responsible for determining whether preparing the financial statements on a going concern historical cost basis is appropriate for the entity. FASB's standards require that management project out their financial position for 12 months beyond the date when the financial statements are issued. Management needs to assess whether there is substantial doubt about the entity's ability to continue as a going concern for that 12-month period. Management then concludes whether preparation of the financial statements as a going concern is appropriate.

B. <u>Condition Analysis</u>

Management is required to identify whether any conditions or events are present during this evaluation that may cause significant doubt about the business entity's ability to continue as a going concern for at least a one-year period of time.

1. Time of Evaluation: This evaluation is made based on the conditions or events that are known at the time they are making that evaluation.

2. Definitions: "Substantial doubt" from the perspective of management is defined by FASB as a "probable" threshold, which means "somewhat likely to occur." It should be noted that AICPA's Section 570, *The Auditor's Consideration of an Entity's Ability to Continue,* does not define "substantial doubt." The auditing standards direct the auditors to consider whatever standard the accounting framework uses. In this case, whatever U.S. GAAP (either FASB or GASB) requires is what the auditor would be required to use.

II. THE AUDITOR'S OBJECTIVE

The auditor is required to consider the evaluation that has been performed by management and then to come to his or her own conclusion on whether the use of the going concern basis is appropriate for preparation of their financial statements. Another requirement is for the auditor to consider the adequacy and the appropriateness of the disclosures around the conditions and events relative to going concern issues.

A. <u>Uncertainty</u>

It would be hard to deny that the pandemic and COVID-19 create events and conditions that may cause doubt about an organization's ability to continue as a going concern. But that's not a blanket, uniform, absolute rule in today's environment. While there are a few businesses that will benefit from the virus, many more already have suffered severe liquidity problems. Further, usually these unfortunate clients may have spent decades building their businesses.

B. Market Analysis

Depending on the market sector in which the business entity operates, the pandemic may or may not cause significant doubt. If the business happens to make toilet paper, the environment is probably not leading you to question their ability to continue as a going concern. On the other hand, if your client is operating a business in the hospitality industry – restaurants, bars, airlines, cruise ships, etc. – the conditions and events likely give rise to a going concern inquiry.

III. MANAGEMENT EVALUATION OF RISK

The next step would be for the auditor to look at, consider, and discuss management's evaluation with them. There is no modern history for this massive meltdown in our economy.

A. Distraction

In today's environment, certainly with today's smaller businesses, management has their hands full with so many things, just keeping the operations going and the doors open, that they may very well have not spent a lot of time considering a going concern evaluation. If management has not performed this evaluation, then the auditor is obligated to ask management to perform the evaluation required by the accounting framework. They may need your assistance to create the evaluation.

B. Questions to be Answered

The first question is, do you agree as an auditor that management has identified all the appropriate conditions and events that need to be considered? Have they extended that evaluation period out for a reasonable period of time? Have they included all relevant information that's available at that date? Remember, management's evaluation should be valid at the point at which they make that evaluation based on known information.

IV. PLANS FOR MITIGATING SUBSTANTIAL DOUBT

When conditions and events have been identified and management has concluded there is in fact substantial doubt about their ability to continue as a going concern, the next step is for the auditor to evaluate any management's plans to effectively mitigate those conditions and events to less than a probable chance of occurring. In other words, the auditor would be asking, "Can management execute these plans, and if executed successfully, would it mitigate substantial doubt about going concern to less than probable?

A. Cash Flow Analysis

This is usually a key process for auditors. Often management is going to be using cash flow forecasts in that evaluation to determine whether their plans can alleviate substantial doubt. The auditor has to make sure the underlying data used in the cash projections is reliable and that management has the appropriate support for the assumptions (such as new external expected financing) they're using in making the projections.

B. External Financing

Does the entity have the ability to access necessary funding from an external third party, a parent entity, an owner-manager, or some other source, such as a banker, new partner, or even the government. If the intent and ability are present, the auditor should obtain written evidence about the intent, preferably from the third-party funding source. And if that's all present, that may lead to a conclusion that the going concern has been alleviated for a reasonable period of time.

C. Possible Sources

The Coronavirus Aid, Relief, and Economic Security Act potential funding that is possibly available through various grants and loan programs with the U.S. SBA and other state or federal programs. Qualifying small businesses may be able to obtain a loan from the SBA to cover payroll and interest on mortgage obligations, as well as rent payments and utility payments for the covered period of that loan. If those funds are expended as intended, the portions of the loan that are expended in accordance with the program may even be forgiven.

D. Insufficient Evidence

Nonetheless, the present potential CARES Act funding on its own may not be enough to alleviate substantial doubt about going concern. Is that funding sufficient to get them through a full 12-month period? Vaccines are coming but their timing and curative effect will vary from industry-to-industry. The auditor needs to take that consideration going forward in determining whether the substantial doubt related to going concern is to be in whole or part alleviated.

V. PARTICULARITY OF PANDEMIC

When management does its projections, auditors need to consider the reasonableness of management assumptions and their client's industry. In today's environment with the pandemic, there is a heightened degree of uncertainty associated with trying to do projections for a 12-month period into the future which time period SAS 132 purports to include. CPAs by nature are conservative but vaccines appear to be on their way which could easily by 2021 year-end be successful thereby eliminating the problem. The jury is still out on the detail of how this will develop. The point here is this whole concern could be temporary for many of our clients.

A. Uncertainty

Auditors should understand that in this environment, it is inevitable that the degree of uncertainty is elevated from what is historically normal. Auditors need to look at those projections with a degree of judgment to assess whether management has done the best they can in making those projections or assessments, based on the information available to them today.

B. Some Inquiries

Are management's assumptions reasonable? That requires a lot of judgment and accurate future cash flow projections just may not be possible in the environment we're now in. We're all going to have to recognize that those requirements have to be met the best they can with the information that's available at the time the evaluation is made. When a going concern evaluation involves projections and there is uncertainty involved, disclosures in the financial statements should highlight the variables, especially as it relates to estimates and projections.

C. Financially Strong Clients

Clients with very strong liquid balance sheets may not have significant doubt about being able to operate as a going concern for a 12-month period just based on the strength of their financials. This is not an automatic rule of thumb or conclusion to be drawn. Cash right now is king. They may have a willing to participate banking reference. You have to look at each circumstance individually and make that assessment.

D. Delay Decision

Would it be prudent for management to delay the issuance of its financial statements until some of this uncertainty is resolved?

1. Variables: This would depend on whether management has the financial and legal flexibility to delay issuance. Certainly, we always have to be thinking about who the users of the financial statements are and whether a delay in the issuance would be acceptable or would be viewed as unacceptable.

2. Prediction Difficulty: There is not a consensus estimate of when this pandemic may start to look better and resolve itself, or when social distancing or travel restrictions may be relaxed. As a result, depending upon the situation, it may be a little naive at this point to think you're going to wait until the economic uncertainty resolves itself to issue financial statements.

VI. REPORTING SUMMARY

Clients are likely most interested in what the auditor's report is going to look like. There are three different types of audit reporting that can result from questioning the entity's going concern evaluation.

A. Unmodified Opinion

1. Substantial Doubt Alleviated: After considering management's plans, including projections and availability of third-party financing or funds, the auditor may conclude that significant doubt has been alleviated. If there's adequate disclosure in the financial statements about those events and conditions and management's plans, the auditor could issue an unmodified report in that case, or may include an emphasis-of-matter paragraph at the auditor's discretion.

2. Disclosure Required: Those disclosures are required in year-end 2020 financial statements by the accounting framework for audits, reviews, and full disclosure compilations. If substantial doubt has been alleviated by management's plans, then management would disclose the conditions and events that gave rise to the substantial doubt as well as their plans for alleviating it, and in that case, there would be no requirement to modify the standard auditor's opinion. You could issue the unmodified opinion.

B. Middle Paragraph

The events and conditions may give rise to considerable doubt about the ability of the entity to continue as a going concern for a reasonable period of time. Then we next consider management's plans, and there may be a conclusion that the substantial doubt would not be significantly alleviated by management's plans. The auditor is required to add an emphasis-of-matter paragraph to the auditor's report that clearly articulates the nature of substantial doubt about going concern and would direct the users to the appropriate disclosures in the financial statements notes.

C. <u>Adverse Opinion</u>

1. Worst Case Outcome: After considering the conditions and events and management's plans, the auditor may conclude that the substantial doubt has not been eliminated and therefore use of the going concern basis of accounting to prepare the financial statements is not appropriate. The auditor plain and simple has to issue an opinion containing the SAS 132 language. Some would suggest the assets then be re-stated at liquidation value but others believe this is too harsh for some unforeseen calamity which has a good chance of abating itself.

2. Less Draconian Treatment: Others would say no, this is merely a temporary disruption and our client's operating management is strong. AICPA suggests the wording "As discussed in the financial statements, the company has suffered losses creating substantial doubt that they may survive as a going concern (see footnote __, infra).

3. Author's Opinion: This author appreciates the CPA's ordinary primary duty to financial statement users dictate disclosure of ordinary normal business insolvency. Still, these inflicted businesses did not do anything wrong and have often spent decades building their business and serving their employees, customers, and communities. Even the IRS in Rev. Proc. 2020.1 relaxes their procedures for individuals and businesses needing assistance flowing from unforeseeable factors beyond their control, such as this pandemic crisis.

4. Consider Lower-Level Service: There is no requirement of extensive disclosure when a CPA performs a "compilation" for a non-public corporation. This author would suggest some pandemic footnotes mention such as "no short-term adjustment has been made for this temporary pandemic." See also https://dart.deloitte.com/USDART/home/publications/deloitte/financial-reporting-alerts/2020/financial-reporting-considerations-economic-downturn-covid

5. Additional Language Possibility: I suggest consideration of adding to the end of the AICPA audit language official wording such as "management of this business remains strong and we recommend third party bankers and shareholders continue to support this deserving business enterprise. In our opinion, based upon our long association, we believe ____________ has the ability and motivation to survive and prosper when the economy returns to normal."

VII. CONCLUSION

We live in uncertain times. Some of our best long-term clients are suffering from something they have no control over. While financial statement reporting is required, many CPAs would prefer to add some positive client information, especially since we are nearing the point of vaccines news that is promising. Footnotes can be used to positively comment on our client's top management and history of many prior successes.