The Going Concern Question in the COVID-19 Crisis

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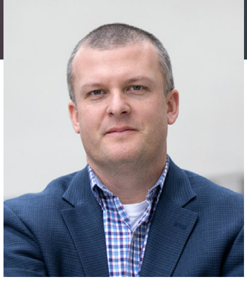
by Eric Hines & Mark Giese



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The COVID-19 pandemic has created unprecedented uncertainty, and businesses across all industries have felt, or will likely feel, the related financial strains and pressures. With customers confined to their homes under mandatory orders to shelter in place, and non-essential businesses closed for the foreseeable future, many corporate executives will be pondering their company's ability to generate sufficient cash flows to support operations. Maintaining compliance with debt covenants, and the related impact on a company's ability to continue under the going concern assumption, will be of particular interest for highly leveraged businesses.

ASC 205-40, "Presentation of Financial Statements - Going Concern," requires management to assess their company's ability to continue to operate within one year after the financial statements are issued or available to be issued. Where there is no substantial doubt about an entity's ability to continue its operations, financial statements are prepared using the going concern assumption (as opposed to liquidation-basis accounting, which assumes that liquidation is imminent). Substantial doubt about an entity's ability to continue as a going concern can arise due to factors such as negative financial trends, internal factors, including work stoppages or needing to significantly modify operations, or external matters such as loss of key vendors.

AU 570, "The Auditor's Consideration of an Entity's Ability to Continue As a Going Concern," requires auditors to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern, and to evaluate the possible financial statement effects, including the adequacy of related disclosures. Where substantial doubt exists, auditors are required to include an emphasis-of-matter paragraph in their audit opinion. Notably, in 2007 and 2008 there was a significant increase in going concern audit opinions for SEC filers, demonstrating that such opinions are more prevalent in times of crisis.

As companies contend with the economic impact of the global pandemic and the related risks, challenges and uncertainties posed, management should be prepared for heightened auditor scrutiny in areas with going concern relevance. Forecasts and projections should be updated to account for specific risks related to issues such as lower demand for products or services, pricing and supply chain issues, and bad debt concerns, all of which could negatively impact cash flows. Management should model out different scenarios, paying particular care to the worst case scenario, and determine the most likely impact on the entity's cash flows and ability to meet its obligations over the coming year. Such models should be updated as additional data and information becomes available.

Even more so than in prior years, auditors will be focused on understanding and testing the underlying data, estimates and judgements supporting management's evaluations, and management should take care to maintain sufficient documentation for these considerations. To the extent the going concern assumption is determined to be at risk, management should also consider viable mitigating options, for example raising additional capital through debt or equity offerings, reducing compensation, deferring planned expenditures, or obtaining federal stimulus relief. Auditors will consider the likelihood of whether such options are available, and if so, whether they would be effective in mitigating the going concern risk.

As noted above, one area of particular concern will be compliance with debt covenants, especially for private equity portfolio companies that typically utilize an aggressive debt strategy to finance their operations. Management and auditors alike will need to carefully consider debt covenant language, especially with respect to going concern risk. For instance, the presence of a going opinion emphasis-of-matter paragraph could trigger a debt covenant provision and exacerbate the cash crunch for an entity that already has elevated liquidity concerns. Unless the entity can obtain a waiver from the debt issuer, or cure the issue within a defined grace period, the related debt would likely require classification as a current liability, further straining liquidity ratios.

Even if management and auditors ultimately conclude that sufficient mitigating options are available to reduce the going concern risk to an acceptable level, and disclose as such in the audit opinion and financial statements, the presence of a going concern emphasis-of-matter paragraph, based on the language of the related debt covenants, could present significant risk for a company. Management, in consultation with internal counsel and others, should carefully consider how a going concern opinion could impact their company's ability to continue operating through the uncertain time ahead.

Key Takeaways

1 Coordinate management's operational plans: Management's first task is understanding and responding to the risks faced by the business. Given the current significant uncertainties, scenario planning should cover a range with respect to both profitability and even more importantly, cash flows. Management's plans will ultimately form the basis of the discussions with the auditor on going concern. Therefore, management in the first instance should be satisfied that the going concern basis of accounting continues to be appropriate, with sufficient basis.

2 Review your organization's debt position: Take particular note of any debt covenant provision that could be inadvertently triggered by the current COVID-19-related economic downturn to protect short-term cash flow. Pay particular attention to how the presence of a going concern paragraph in the audit opinion could impact debt covenants.

3 Stay in close contact with your auditor: Heightened auditor scrutiny should be expected in areas with going concern relevance. Get ahead of any potential audit issues by speaking frequently with your audit team and consistently assessing your business's ability to meet its financial obligations in worst, likely and best case scenarios.

4 Re-evaluate your options: If there is a "going concern" risk, management should consider all available mitigating options, such as deferring planned expenditures, obtaining federal stimulus relief or even raising additional capital through debt or equity offerings. Put all viable options on the table in order to best navigate the uncertainty ahead.

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