

COVID-19 UPDATE: FINANCIAL REPORTING AND AUDITING CONSIDERATIONS FOR CORPORATE MANAGEMENT, AUDIT COMMITTEES, AND AUDIT FIRMS

To Our Clients and Friends:

As the disruption caused by COVID-19 continues unabated, companies and their outside auditors are grappling with the financial reporting implications of the crisis. There are numerous, immediate regulatory responses to the crisis that issuers should consider, including, for example, the reporting relief recently announced by the Securities and Exchange Commission (principally a 45-day delay in certain filing requirements) or under the CARES Act (in the form of relief from certain accounting standards).[1] Similarly, auditors should remain aware of the steps that the Public Company Accounting Oversight Board is taking to address the disruption in normal business activity, primarily permitting firms to request a 45-day delay in certain aspects of their PCAOB inspections.[2]

Beyond those process developments, there are also areas of substantive financial reporting that issuers and their auditors should consider as they prepare for annual or quarterly periodic reporting. As management and audit committees undertake to see that their financial statements are fairly presented in this fast-paced and ever-changing environment, and as auditors audit or conduct review procedures on these financials, they should not lose sight of the potential reaction that regulators may have in the future to accounting judgments and disclosure decisions, or to the prospect that those decisions may be scrutinized through the lens of twenty-twenty hindsight in future private shareholder litigation. Simply put, this is not business as usual for anyone. It is more important than ever that corporate management and audit committees focus on certain key financial reporting and accounting issues in these unsettling times. Similarly, auditors should consider these issues and evaluate how those and other considerations will affect their audits and reviews of upcoming financial statements.

Issuer Considerations: Potential Legal Exposure Related to Select Accounting and Financial Reporting Areas

The impact of COVID-19 on companies across all facets of the economy cannot be underestimated, and many companies will likely be confronted by significant employee layoffs and financial losses in the months to come. Although this environment remains wildly unpredictable even for the most sophisticated analysts, there are certain areas of financial reporting for which there is heightened potential for second-guessing by regulators and private plaintiffs. Those areas include (i) management estimates, including goodwill and asset impairment, (ii) lease accounting, (iii) going concern evaluations, (iv) internal controls over financial reporting, and (v) the use and disclosure of non-GAAP measures and performance metrics.

Estimates and Impairment

In recent decades, financial reporting has relied more and more on management estimates concerning the fair values of assets and the potential impairment of those assets, including goodwill and intangible asset impairment. Even in the most stable of times, fair value estimates and impairment assessments can present a minefield of difficult questions, as evidenced by the fact that goodwill and intangible asset valuation is the most frequent subject of critical audit matters identified in external auditors' reports, according to the PCAOB.[3]

The recent turmoil wrought by the pandemic has added exponentially to the difficulty of reaching reasonable and supportable accounting judgments in this area. Both the SEC and PCAOB have acknowledged in their recent public statements that estimate and impairment accounting will be one of the areas most affected by the interruption of normal business activity during the crisis.[4] Although these statements highlight that regulators are well aware of these challenges and sound a note that the regulatory community will exercise caution before second-guessing well-reasoned judgments,[5] management and audit committees should not let their guard down and should appreciate that after-the-fact scrutiny of estimation and impairment processes and determinations likely will be intense. This holds true across numerous circumstances, from the estimation of insurance loss reserves to the analysis of goodwill from recent acquisitions for potential impairment.

As issuers prepare their upcoming periodic reports—whether they include disclosures concerning annual impairment testing or potential disclosure of a triggering event requiring an interim impairment—management and audit committees should keep in mind that potential legal exposure accompanies both the decision to write down or impair assets and the decision not to do so.

- For example, an issuer that takes a conservative view regarding the impact that the crisis will have on its operations and the value of its assets going forward might announce a significant write-down or impairment. However, if the company or its industry recovers quickly following the crisis, a regulator or private plaintiff may claim the company used the COVID-19 crisis as a cover to write down the value of assets to mask earlier mismanagement of the enterprise.
- On the other hand, an issuer that predicts the current crisis will be short-lived or that business will soon recover to pre-crisis levels may elect to reflect no or minimal asset write-downs and impairments. That decision could be subject to second-guessing should the company's forecast prove optimistic and a long economic slump ensue. Even a subsequent write-down or impairment charge could expose the company to claims that it intentionally delayed the inevitable.

In light of this dilemma, issuers should consider what steps to take to help ensure that their valuation estimates and impairment decisions are reasonable in light of all facts that are presently known. For material estimates and impairments, companies should strongly consider obtaining objective and independent assessments and updating those analyses on a quarterly basis going forward. And the entire process should be well documented, including written assessments that explain the process, the critical assumptions, the timing of any write-down or change in estimate, and an explanation of why the estimate is well supported and reasonable in the circumstances in the period recorded.

Lease Accounting

In 2019, issuers began to implement the revised accounting standard ASC 842 to bring operational leases onto their financial statements, which for many represented a significant change to their accounting.[6] Barely a year into that change, companies will now have to grapple with the accounting implications of a worldwide economic interruption which is reportedly leaving large numbers of companies unable to meet the financial obligations under lease agreements.[7] As with impairment and valuation considerations, issuers will need to determine whether and how to restructure their lease relationships in a period of significant uncertainty, knowing that regulators and private plaintiffs will scrutinize those decisions with the benefit of hindsight.

On April 8, 2020, the Financial Accounting Standards Board provided some relief for companies applying ASC 842 when it voted to relax the requirement that leases be individually reviewed as potential modifications. Recognizing that many changes to normal leasing relationships are being implemented through existing provisions in the leases, such as force majeure clauses, rather than by modifying the lease contract, FASB determined that it would be unduly burdensome for issuers to conduct an individualized analysis concerning whether each change in lease payments constituted a modification.[8] As a result, FASB will now allow companies to temporarily account for lease concessions related to the impacts of COVID-19 consistent with how those concessions would have been accounted for had enforceable rights and obligations for those concessions existed (regardless of whether those enforceable rights and obligations explicitly exist in the contract). Consequently, for concessions related to the impacts of the ongoing crisis, an entity will not have to analyze each individual contract.[9] FASB's recent action will provide short-term relief to issuers in preparing financial statements in accordance with GAAP. However, Companies will need to take steps to see that their categorization decisions and modification analysis are reasonable, and that those determinations are well documented.

Other potential areas of lease accounting for which issuers can expect scrutiny include:

- *The content of any risk factors they include in upcoming filings related to the COVID-19 crisis.* Companies for which modifications to leases could materially affect their accounting and financial results should consider explicitly noting leases as an aspect of their risk factor disclosures about the impact of the pandemic on business operations.
- *Right of Use (ROU) accounting.* A ROU asset is a lessee's right to hold, operate, or occupy the leased property over the lease term. Lessees that have recognized an ROU asset on the balance sheets will have to consider whether changes to their leasing relationships as a result of the crisis affect the recognition of ROU assets, including the amortization of those assets.

Going Concern

With so many companies experiencing unprecedented financial turmoil due to the pandemic, an aspect of that issuers should not overlook is the GAAP requirement that "an entity's management at the date the financial statements are issued should evaluate whether there are conditions and events, considered in the aggregate, that raise substantial doubt about an entity's ability to continue as a going concern

within one year after the date that the financial statements are issued.”^[10] In light of both the significant economic trauma that the COVID-19 crisis has caused and the uncertainty regarding how long it will last, issuers may find that their going concern analysis now requires different considerations than it would in normal times.

Of course, as with other issues discussed in this update such as goodwill and asset impairment, regulators and private plaintiffs will have the benefit of hindsight in making allegations against companies that do not survive the current crisis, and might assert that substantial doubt about the company’s continuation clearly existed, or should have been recognized by the company, at the time that the financial statements were issued. Issuers can protect themselves in part against such claims by considering whether the documentation of their going-concern analysis is sufficiently robust.

Internal Controls

Management, audit committees, and auditors also need to recognize that perceived violations of GAAP or disclosure requirements could lead to subsequent regulatory scrutiny or allegations by private plaintiffs that an issuer’s internal control over financial reporting was not effective. For example, regulators or plaintiffs may later allege that the furlough or termination of certain employees or the challenges created by a newly remote work force degraded a company’s internal controls, leading directly to improper accounting or disclosure in one of the above areas.

It is therefore important that issuers focus on risks to the design and operation of internal control during this period of disruption. Among the circumstances that could arise during the crisis and that could interfere with the normal operation of the internal-control system are:

- The closure of business facilities and off-site work arrangements may prevent certain controls, including periodic and compensating controls, from operating;
- Staff furloughs, illnesses, and remote work may cause managers to modify workstreams to the detriment of the segregation of duties; and
- The uncertainty, business disruptions, and market turmoil caused by the crisis may interrupt the normal flow of information, including information from third-party sources, on which certain controls rely.

Management and audit committees should therefore consider what steps they can take to buttress their internal controls during this time, to protect themselves internally and externally.

Non-GAAP Financial Measures

The use of non-GAAP financial measures has been the subject of recent regulatory scrutiny as the SEC has examined whether companies use non-GAAP financial measures to present an overly optimistic picture of their business performance. At this point, most companies are well aware of the SEC’s extensive guidance in the past few years designed to promote robust and careful use of non-GAAP financial measures in issuer disclosures.^[11]

The SEC's enforcement of this guidance has included not only policing the formulation and consistency of the metrics themselves but also, in late 2018, an enforcement order alleging that an issuer inappropriately gave a non-GAAP financial measure equal prominence with the analogous GAAP measure.^[12]

Scrutiny on the use of non-GAAP financial measures also has been subject of recent criminal prosecution. For example, on August 1, 2019, the same day that the SEC charged a real estate investment trust with improperly adjusting a non-GAAP measure allegedly to mislead investors about the company's growth,^[13] the U.S. Attorney's Office for the Southern District of New York announced criminal securities fraud charges against the company's former chief executive officer and chief financial officer.^[14]

Given the level of scrutiny currently being applied to non-GAAP financial measures by regulators and prosecutors, issuers should consider whether additional attention to their processes to calculate and present any non-GAAP financial measures is warranted in this environment.

Auditor Considerations: Potential Legal Exposure Related to Current Audit Work

It should come as no surprise to external auditors that the accounting and disclosure challenges faced by their clients also have potential implications for the auditors' own regulatory or litigation exposure. The PCAOB's statements during the crisis and its enforcement actions arising out of the 2008 financial crisis provide a guide to some of the points of potential scrutiny that PCAOB-registered firms can anticipate.

On April 2, 2020, the PCAOB released a Spotlight document entitled, "COVID-19: Reminders for Audits Nearing Completion."^[15] Consistent with the PCAOB's focus on risk assessment and response as a foundation of the audit, the document discusses at length the effect that the current crisis may have on an auditor's risk-assessment process:

As part of the evaluation of whether sufficient appropriate audit evidence has been obtained, auditors are required to evaluate the appropriateness of their initial risk assessments. **In light of the economic effects of the COVID-19 crisis, new risks may emerge, or the assessments of previously identified risks may need to be revisited because the expected magnitude and likelihood of misstatement has changed.** Changing incentives or increased pressures on management, especially when taken together with changes in internal controls or increased ability for management override of controls, may result in new risks of material misstatement due to fraud or changes to the auditor's previous assessment of risks of material misstatement due to fraud. Similarly, increased pressure on, and changes in, management processes, systems, and controls may give rise to increased risk of error. **Initial responses to assessed risks may not be adequate given the revised risk assessments, or planned procedures may not be practical or possible to perform under current circumstances.**^[16]

As the PCAOB notes, the response to a modified risk assessment may itself be affected by the interruption of normal business activity, including that the nature and form of audit evidence may need to change as certain evidence relied upon in the past may no longer be available.^[17]

The PCAOB's Spotlight document also addresses other potential effects of the present crisis on the planning and performance of the audit, including:

- Financial statement areas that may be affected by the current economic turmoil, including several of those noted above;
- Changes that may need to occur in audit committee communications or in the auditor's report, including the identification of any new critical audit matters; and
- The potential need to modify the operation of certain quality-control processes, including the engagement quality review, in light of current business restrictions.^[18]

The PCAOB notes in the Spotlight that certain of its publications issued during the most recent financial crisis and recession may provide a guide to relevant audit considerations in the present.^[19] The PCAOB's enforcement actions related to that financial crisis also provide a useful guidepost to the areas of scrutiny that auditors can expect as they emerge from this present crisis.

Perhaps the most high-profile PCAOB enforcement action related to the previous financial crisis was its proceeding against an engagement partner related to a mortgage lender's restatement of its financial statements based on revised loan asset valuations. The matter concerned two of the financial statement areas that we discuss above as being potentially relevant to the current crisis—management estimates concerning asset valuation, and evaluation of an entity's ability to continue as a going concern. In that matter, the PCAOB charged the engagement partner with a failure to exercise due professional care, including professional skepticism; a failure to obtain sufficient audit evidence; and an inappropriate reliance on management representations, all related to both her procedures related to the value of the lender's mortgage assets and her consideration of the lender's ability to continue as a going concern.^[20]

Although the SEC later overturned the PCAOB's sanction of the engagement partner,^[21] we expect that the case remains a reliable guide to the types of allegations the PCAOB may bring in the future concerning auditing decisions made today. That matter, therefore, along with the April 3 Spotlight document, highlights areas to which auditors should remain attentive as they perform audit and review procedures in this difficult environment, including: (i) exercising adequate professional care, including professional skepticism; (ii) obtaining sufficient appropriate audit evidence and not becoming overly reliant on management representations; and (iii) properly identifying and assessing the risks of material misstatement, as well as fashioning an appropriate response to those risks in light of the current difficulty in carrying out business operations. As always, the likelihood of an enforcement action by the SEC or PCAOB may depend in part on whether an auditor's judgments on these and other relevant issues is adequately documented in the written work papers.

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Issuers and external auditors have already recognized that the accounting and auditing judgments that they make today during the COVID-19 crisis could be the target of litigation and regulatory investigations down the road. It is important that companies and auditors assess which aspects of their financial reporting, disclosure, and audit processes are most likely to be subject to scrutiny during and

after the present crisis, and to take steps now to help ensure that decisions on those points are reasonable and defensible.

In its April 3, 2020 statement, the SEC Office of Chief Accountant emphasized the availability of its consultation process for issuers facing especially challenging financial reporting questions during this time.^[22] When confronted with particularly complex financial reporting issues, management should consider using this invitation for consultation. Gibson Dunn’s lawyers also stand ready to assist with any questions you may have regarding these or other financial reporting developments related to the COVID-19 crisis, or assisting in the consultation process. For further information, please contact the Gibson Dunn lawyer with whom you usually work, or the following authors in Washington, New York, Denver, and Palo Alto.

[1] The SEC’s filing relief is discussed in more detail in Gibson Dunn’s Securities Regulation Monitor blog, *available at* <https://www.securitiesregulationmonitor.com/Lists/Posts/Post.aspx?ID=402>, and our April 9, 2020 Client Update, *Perspectives from One Month into the COVID-19 U.S. Outbreak: Public Company Disclosure Considerations*, *available at* <https://www.gibsondunn.com/perspectives-from-one-month-into-the-covid-19-u-s-outbreak-public-company-disclosure-considerations/>. A Gibson Dunn summary of the CARES Act is located at <https://www.gibsondunn.com/senate-advances-the-cares-act-to-stabilize-economic-sector-during-coronavirus-pandemic/>. On April 3, 2020, SEC Chief Accountant Sagar Teotia clarified that the SEC Office of the Chief Accountant will consider a company’s decision to structure its financial reporting consistent with the CARES Act accounting provisions to be compliant with GAAP. *See* Statement on the Importance of High-Quality Financial Reporting in Light of the Significant Impacts of COVID-19 (Apr. 3, 2020) (Teotia Statement”), *available at* <https://www.sec.gov/news/public-statement/statement-teotia-financial-reporting-covid-19-2020-04-03>.

[2] *See* “In Light of COVID-19, PCAOB Provides Audit Firms with Opportunity for Relief from Inspections” (Mar. 23, 2020), *available at* <https://pcaobus.org/News/Releases/Pages/In-Light-of-COVID-19-PCAOB-Provides-Audit-Firms-with-Opportunity-for-Relief-from-Inspections.aspx>.

[3] *See* “Spotlight – Critical Audit Matters” (Dec 10, 2019), *available at* <https://pcaobus.org/Documents/CAMs-Spotlight.pdf>.

[4] *See* Division of Corporation Finance, CF Disclosure Guidance: Topic No. 9 (Mar. 25, 2020), *available at* <https://www.sec.gov/corpfin/coronavirus-covid-19>; “Spotlight – COVID-19: Reminders for Audits Nearing Completion” (Apr. 2, 2020) (“PCAOB Spotlight”), *available at* <https://pcaobus.org/Documents/COVID-19-Spotlight.pdf>.

[5] *See* Teotia Statement (“OCA has consistently not objected to well-reasoned judgments that entities have made [concerning judgments and estimates], and we will continue to apply this perspective”).

[6] *See* FASB Accounting Standards Update 2016-02, Leases (Topic 842) (Feb. 25, 2016).

[7] See “Businesses Can’t Pay Rent. That’s a Threat to the \$3 Trillion Commercial Mortgage Market,” [wsj.com](https://www.wsj.com) (Mar. 24, 2020).

[8] See Gibson Dunn’s Client Update concerning force majeure clauses, *available at* <https://www.gibsondunn.com/force-majeure-clauses-a-4-step-checklist-and-flowchart/>.

[9] See FASB Staff Q&A—Topic 842 and Topic 840: Accounting for Lease Concessions Related to the Effects of the COVID-19 Pandemic.

[10] ASC 205-40-50-1.

[11] See “Non-GAAP Financial Measures,” *available at* <https://www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm>.

[12] See, e.g., ADT, Inc., Rel. No. 34-84956 (SEC Dec. 26, 2018).

[13] Brixmor Property Group Inc., Rel. No. 34-86538 (SEC Aug. 1, 2019).

[14] “Former Chief Executive Officer And Chief Financial Officer Of Publicly Traded Company Charged With Accounting Fraud” (Aug. 1, 2019), *available at* <https://www.justice.gov/usao-sdny/pr/former-chief-executive-officer-and-chief-financial-officer-publicly-traded-company>.

[15] See PCAOB Spotlight.

[16] *Id.* at 2 (emphasis added).

[17] *Id.* at 2-3.

[18] *Id.* at 3-5.

[19] *Id.* at 6 (citing PCAOB Staff Audit Practice Alert No. 9, “Assessing and Responding to Risk in the Current Economic Environment” (Dec. 6, 2011); PCAOB Staff Audit Practice Alert No. 3, “Audit Considerations in the Current Economic Environment” (Dec. 5, 2008)).

[20] Cynthia C. Reinhart, CPA, Rel. No. 34-85964, at 15 (SEC May 29, 2019).

[21] See *generally id.* The SEC disagreed in part with the PCAOB’s factual findings and also overturned the PCAOB’s analysis concerning what constituted “repeated instances of negligent conduct” sufficient to support the imposition of heightened sanctions pursuant to section 105(c)(5)(B) of the Sarbanes-Oxley Act of 2002, as amended. See 15 U.S.C. § 7215(c)(5)(B).

[22] Teotia Statement (“We remain available for consultation and encourage stakeholders to contact our office with questions they encounter as a result of COVID-19”).



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*Gibson Dunn's lawyers are available to assist with any questions you may have regarding developments related to the COVID-19 outbreak. For additional information, please contact any member of the firm's **Coronavirus (COVID-19) Response Team**.*

Authors: *Michael Scanlon, Lee Dunst, Lawrence Zweifach, Monica Loseman, David Ware, and Chris Trester*

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