

## **KEY CONSIDERATIONS FOR ISSUERS AND AUDITORS REGARDING GOING-CONCERN ANALYSIS**

To Our Clients and Friends:

Issuers in the United States and their auditors have related, but distinct, obligations to evaluate on a periodic basis whether there is substantial doubt about the issuer's ability to continue as a going concern.<sup>[1]</sup> In normal times, this evaluation, conducted with an appropriate level of diligence, results as to almost all major public companies in the conclusion that there is no substantial doubt about the entity's ability to meet its obligations in the months to come.

But these are not normal times. As the COVID-19 crisis takes an ever-greater toll on the American economy, and as multiple well-known companies declare bankruptcy,<sup>[2]</sup> the going-concern assessment has taken on new relevance for issuers, auditors, and others in the financial-reporting community. As a result, the number of issuer filings that contain a going-concern disclosure appears to have substantially increased.<sup>[3]</sup> In this piece, we review some of the significant considerations that apply to the going-concern analysis from both the issuer's and the auditor's perspectives.

### **Summary of Issues**

- Financial Accounting Standards Board ("FASB") accounting standards and PCAOB auditing standards both require an assessment of whether there is substantial doubt about the issuer's ability to continue as a going concern, including evaluating concrete management plans to address the circumstances giving rise to the reasonable doubt. The auditor is required to make an independent assessment, not simply evaluate management's process.
- Important differences between the accounting and auditing standards include that the management assessment occurs quarterly and looks forward one year from the date the financial statements are issued, whereas the auditor annually considers the period one year from the balance sheet date, with different quarterly review procedures.
- Both auditors and issuers should anticipate potential exposure to regulatory and private litigation should their forecasts of the effects of the COVID-19 pandemic prove inaccurate.

### **Background**

American Institute of Certified Public Accountants ("AICPA") and, later, PCAOB auditing standards have for decades required auditors to evaluate on an annual basis whether there is substantial doubt about the ability of the audited entity to continue as a going concern.<sup>[4]</sup> Under current PCAOB standard AS 2415, an auditor assesses, based on the relevant information obtained during the audit,<sup>[5]</sup> whether

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substantial doubt exists about the entity's ability to meet its obligations as they come due over a reasonable period of time after the balance sheet date (not to exceed one year in the future) without the entity's having to resort to measures such as disposing of significant assets or restructuring its debt.[6] The relevant information could include evidence such as negative operating trends, loan defaults, loss of key customers or patents, or even natural disasters.[7] If the auditor concludes that substantial doubt does exist, then as a second step it is required to consider management's plans to address the circumstances giving rise to the substantial doubt, such as selling assets, restructuring debt, or raising capital. Under AS 2415, the auditor's focus is on whether those plans are feasible and whether the assumptions underlying them are reasonable, such that they represent an adequate plan to address the circumstances.[8] If the auditor concludes even after assessing management's plans that substantial doubt about the entity's ability to meet its obligations over the coming year still exists, then the auditor must, among other steps, include an explanatory paragraph to that effect in the audit report.[9]

In addition, if an auditor, during an interim review of an entity's quarterly financial statements, becomes aware of "the entity's possible inability to continue as a going concern," the auditor is required to make certain inquiries of management and assess whether management's disclosures are adequate.[10]

On top of this established framework, the FASB in 2014 adopted a requirement that companies make their own assessments on a quarterly basis of their ability to continue as a going concern, a requirement codified as ASC Subtopic 205-40.[11] Subtopic 205-40 differs from the PCAOB's AS 2415 in some important ways. For example, unlike the PCAOB, the FASB defined the concept of "substantial doubt" in connection with its standard: specifically, it stated that substantial doubt exists as to an entity's ability to continue as a going concern "when conditions and events, considered in the aggregate, indicate that it is **probable** that the entity will be unable to meet its obligations as they become due within one year after the date that the financial statements are issued." [12] In other respects, Subtopic 205-40 bears close similarities to AS 2415, including in the circumstances that can indicate that substantial doubt exists and in the requirement to assess management plans to alleviate the substantial doubt.[13]

Even apart from the considerations specific to the COVID-19 crisis, there are two differences between Subtopic 205-40 and AS 2415 that are important to bear in mind:

- *First*, management's disclosure obligations differ from those of the auditor. While the auditor's disclosure consists of an explanatory paragraph in the audit report,[14] management's disclosure of substantial doubt about its ability to continue as a going concern is found in the notes to the financial statements and management typically also includes disclosure of the issue in the liquidity section of management's discussion and analysis ("MD&A"), as well as in the issuer's risk factors.[15] Additionally, under Subtopic 205-40, where an issuer that concludes that management's plans have alleviated the substantial doubt about its ability to meet its obligations, the issuer still must disclose in the notes to the financial statements that substantial doubt existed in the absence of those plans.[16] AS 2415, on the other hand, does not require disclosure by the auditor in situations where management's plans have alleviated the substantial doubt.
- *Second*, while management's obligation to evaluate its going-concern status is identical at the annual and quarterly stages,[17] the auditor's obligations vary considerably between year-end

and quarter-end. Unlike many audit procedures, in which the auditor evaluates the reasonableness of management’s accounting or disclosures, the annual going-concern analysis represents a standalone process for the auditor to arrive at a conclusion regarding the entity’s status.[18] In an interim review, by contrast, the procedures are both more limited and more tied to management’s assessment.[19]

Although global pandemics were not included on the list of adverse conditions in either AS 2415 or Subtopic 205-40, the economic shock that COVID-19 has created will provide a basis for many companies and auditors to conduct a more searching going-concern analysis than usual in the months to come. As we address in the next section, this analysis will be especially difficult in a crisis such as COVID-19 whose duration and economic effects are so unpredictable. We will then address some other key considerations for issuers and auditors as they assess the potential for substantial doubt to exist concerning management’s ability to meet upcoming obligations.

## **Addressing the Significant Uncertainty of the COVID-19 Crisis**

The list of adverse events set out in AS 2415 and Subtopic 205-40 that could potentially call a company’s viability into question includes items such as negative operating trends, work stoppages, and loan defaults.[20] In some cases, the ultimate outcome of those events or circumstances will be uncertain at the time of management’s or the auditor’s assessment. The COVID-19 pandemic, however, raises a set of global uncertainties—concerning areas from public health to financial markets—whose complexity is an order of magnitude greater than that of the circumstances that may drive an entity’s going-concern analysis in normal times.

While Subtopic 205-40 requires only that an entity assess its ability to meet its obligations based on “relevant conditions and events that are known and reasonably knowable at the date that the financial statements are issued,”[21] and AS 2415 similarly requires only that the auditor consider “his or her knowledge of relevant conditions and events that exist at or have occurred prior to the date of the auditor’s report,”[22] both issuers and auditors should be aware that regulators and private plaintiffs will later assess their actions with twenty-twenty hindsight. Plaintiffs, in particular, will have an incentive to ignore that the auditor “is not responsible for predicting future conditions or events,”[23] and likely will seek to claim that the events of the next year were clearly on the horizon at the time that companies and auditors issued their financial statements and reports, based on the progression of the COVID-19 crisis as of that time. In assessing the risk that an entity will be unable to meet its obligations in the coming months, both issuers and auditors should anticipate that they will face potential legal exposure for failing to accurately predict the future.

In the current environment, both management and auditors are likely best served by: (i) making, documenting, and disclosing a good-faith attempt to identify the operational, financial, and economic factors that will affect the company’s ability to meet its obligations in the coming year, including those that are likely to indicate a worse outcome for the company; (ii) comprehensively documenting what they believe is known and reasonably knowable, as of their assessment date, about the implications of each factor for the company’s ability to meet its obligations in the coming months—including, as appropriate, based on consultation with third-party experts such as outside counsel or valuation experts;

and (iii) making, and documenting, a good-faith assessment, based on that forecast, of how likely it will be that a point arrives within the relevant timeframe at which, individually or in the aggregate, one or more of those factors causes the company to be unable to meet its obligations as they come due.

## **Other Key Considerations**

In addition to the problem of uncertainty in the progression of the COVID-19 crisis, there are other considerations that issuers and auditors should bear in mind as they conduct their going-concern assessments.

*First*, if an entity's management concludes that substantial doubt exists concerning its ability to meet its obligations absent management plans to address the situation, then management should keep in mind the requirements that apply to the plans that it develops. Subtopic 205-40 makes clear that substantial doubt about an entity's ability to continue as a going concern is alleviated only if two conditions are met: (i) "It is probable that management's plans will be effectively implemented within one year after the date that the financial statements are issued," and (ii) "It is probable that management's plans, when implemented, will mitigate the relevant conditions or events that raise substantial doubt about the entity's ability to continue as a going concern within one year after the date that the financial statements are issued."<sup>[24]</sup>

Concerning the first condition, the standard states that for management's plans to be considered probable for implementation, they generally must already have been approved by management at the time the financial statements are issued.<sup>[25]</sup> That is, they should generally not be merely theoretical or even under active consideration. This means that, if management anticipates that its quarter-end analysis may lead to an initial conclusion that substantial doubt exists concerning its ability to continue as a going concern, it should take anticipatory steps during the quarter to plan its response, to help ensure that it has time to approve any alleviating plans that may become necessary.

Concerning the second condition, Subtopic 205-40 states that the magnitude and timing of management's plans must be measured against "the magnitude and timing of the relevant conditions or events that those plans intend to mitigate."<sup>[26]</sup> If, for example, management adopts a plan to address its liquidity needs that will not become effective until after the principal period of its liquidity shortfall has passed, then it may be difficult for it to conclude that the plan is effectively timed to alleviate the substantial doubt concerning its ability to meet its obligations. Issuers should try to ensure, therefore, that they develop plans that will realistically meet their expected liquidity and related needs in terms of both timing and magnitude.

Management should remain aware as to both of these conditions that the probability of execution or success that it assigns to its plans may differ from the probability that its auditor assigns to those same plans; thus, if it hopes to avoid a going-concern explanatory paragraph in the audit report, it will need to communicate early and often with the auditor to understand the auditor's views as to how it anticipates evaluating management's plans.

*Second*, PCAOB standards similarly prescribe particular considerations should an auditor initially conclude that substantial doubt about the entity's ability to continue as a going concern does exist such that management's plans become relevant. AS 2415 directs the auditor to focus especially on two points:

(i) “those elements that are particularly significant to overcoming the adverse effects of the conditions and events,” and (ii) any “prospective financial information [that] is particularly significant to management’s plans.”<sup>[27]</sup> The standard requires the auditor to obtain audit evidence specifically to address the most significant aspects of management’s plan, including the evidence that supports management’s assumptions about the prospective financial effects of its plans. This information should be considered with appropriate professional skepticism, and the auditor should keep in mind that the PCAOB would likely conclude that the provisions of auditing standards that require an auditor to consider contrary audit evidence would apply to this exercise.<sup>[28]</sup>

*Third*, complications may arise even after the annual audit if the issuer intends to incorporate by reference its financial statements with the Securities and Exchange Commission (“SEC”) as part of a registered offering conducted pursuant to the Securities Act of 1933, as amended. If the issuer does incorporate its financial statements by reference, the issuer is required to obtain the auditor’s consent to include the audit report as part of the registered offering. PCAOB standards require auditors to conduct certain procedures in that situation,<sup>[29]</sup> and if as a result of those procedures the auditor determines that its audit report would be misleading in the absence of a going-concern explanatory paragraph (even though the conditions giving rise to the substantial doubt occurred after the issuance of the report), then the auditor might re-issue its audit report to include a going-concern explanatory paragraph and require that the issuer update its financial statements to reflected this added disclosure. Depending on the timing, this re-issuance may or may not occur in conjunction with the issuer’s conducting its own quarterly evaluation of its ability to continue as a going concern.

*Fourth*, there is a slight discrepancy between the time period applicable to an issuer’s going-concern analysis and that applicable to the auditor, but the period during which both parties obtain the evidence that is relevant to their analysis is the same.

AS 2415 states that the auditor’s going-concern evaluation is conducted with reference to the balance-sheet date; meanwhile, Subtopic 205-40 states that management’s evaluation should occur as of the date the financial statements are issued.<sup>[30]</sup> FASB noted in adopting Subtopic 205-40 that it had received input “from many auditors indicating that, in practice, they already assess over a period of one year from the audit report date instead of one year from the balance sheet date.”<sup>[31]</sup> More importantly, however, AS 2415 makes clear that the auditor’s consideration of the going-concern question must be “based on his or her knowledge of relevant conditions and events that exist at or have occurred prior to *the date of the auditor’s report*.”<sup>[32]</sup> The fact that the auditor’s balance-sheet date is used as a reference date, then, does not provide the auditor with an excuse to ignore subsequent events that occur prior to the audit report.

A recent SEC case addressing an auditor’s going-concern analysis demonstrated this fact in practice. *In the Matter of the Application of Cynthia C. Reinhart, CPA* was an appeal to the SEC from sanctions that the PCAOB had ordered be imposed on the engagement partner for an audit of a mortgage lender, Thornburg Mortgage, Inc. (“Thornburg”).<sup>[33]</sup> The PCAOB charged that Ms. Reinhart had, among other things, failed to properly assess whether there was substantial doubt about Thornburg’s ability to continue as a going concern. Although the SEC recognized that Ms. Reinhart and her team had, consistent with AS 2415, assessed the question of substantial doubt over a period lasting until the

following fiscal year end, the SEC’s discussion of the sufficiency of her assessment concentrated in large part on events that occurred between the balance-sheet date and the report date, such as fluctuations in Thornburg’s ability to meet margin calls leading up to the filing of its Form 10-K.[34] The *Reinhart* case is a useful reminder that the difference between management’s and the auditor’s reference date does not create any distinction between them in terms of the available evidence that may affect their assessment.

*Fifth*, it has been discussed that auditors may be concerned about issuing going-concern opinions in part because doing so could accelerate the financial decline of the entity being audited, such that the going-concern paragraph becomes a self-fulfilling prophecy.[35] Given the widespread economic dislocations that the COVID-19 crisis has caused, there may be reason to think that the stigma of a going-concern opinion is not as acute as it has been under normal circumstances. In either case, however, audit engagement teams should keep in mind that protecting their own, and their firms’, interests depends on the team ensuring that it considers the relevant evidence with appropriate skepticism and documents that its process was thorough and appropriate.

*Sixth*, issuers should seek counsel sooner rather than later about their fiduciary obligations when potential going-concern issues exist because it is critical that officers and directors fully understand their fiduciary obligations and how best to comply with them and make reasoned, disinterested, good faith decisions that receive the benefit of the business judgment rule. Members of the Firm’s Business Restructuring and Reorganization Group can assist officers and directors to understand and comply with these obligations.

## Conclusion

Hopefully, the period when going-concern analyses occupy a heightened level of attention will pass in the coming months as the COVID-19 health crisis wanes and the U.S. and world economies rebound. Until that time comes, issuers and auditors should ensure that they are approaching the going-concern analysis with the care that it will now warrant.

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[1] This alert focuses on the considerations applicable to issuers who report their financial statements on the basis of U.S. Generally Accepted Accounting Principles and to audits of those issuers performed pursuant to Public Company Accounting Oversight Board (“PCAOB”) auditing standards. We note, however, that International Financial Reporting Standards (“IFRS”) also contain a requirement that an entity assess its status as a going concern. *See* IAS 1.25, *Presentation of Financial Statements*. As a result, many of the observations contained herein may also be relevant to issuers who report using IFRS.

[2] *See, e.g.*, Hertz Global Holdings, Inc., Form 8-K filed May 26, 2020; J. C. Penney Co., Inc., Form 8-K filed May 18, 2020; J.Crew Group, Inc., Form 8-K filed May 4, 2020.

[3] Among the companies that have recently issued going-concern notices are: Chesapeake Energy Corp., *see* Form 10-Q filed May 11, 2020; and Dave & Buster’s Entertainment, Inc., *see* Form 10-K



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filed Apr. 3, 2020. *See also* SandRidge Energy, Inc., Form 10-Q filed May 19, 2020 (disclosing substantial doubt concerning ability to continue as a going concern alleviated by management plans to sell headquarters).

[4] *See* AU § 341, *The Auditor’s Consideration of an Entity’s Ability to Continue as a Going Concern*. AU Section 341 was adopted as an interim standard by the PCAOB pursuant to PCAOB Rule 3200T, *see* PCAOB Rel. No. 2003-006 (Apr. 18, 2003), and is now codified in PCAOB auditing standards as AS 2415, *Consideration of an Entity’s Ability to Continue as a Going Concern*.

[5] AS 2415 does not require any procedures to be performed solely for purposes of the going-concern evaluation. Instead, it contemplates that “[t]he results of auditing procedures designed and performed to achieve other audit objectives should be sufficient for that purpose.” AS 2415.05.

[6] AS 2415.01-.03.

[7] AS 2415.06.

[8] AS 2415.07-.09.

[9] AS 2415.12.

[10] AS 4105.21, *Reviews of Interim Financial Information*.

[11] *See* Accounting Standards Update No. 2014-15, *Disclosure of Uncertainties About an Entity’s Ability to Continue as a Going Concern* (Aug. 2014) (“ASU 2014-15”).

[12] ASU 2014-15, *Glossary* (emphasis in original, other emphasis removed). FASB made clear that the term “probable” as used here has the same meaning as it does in the context of assessing loss contingencies under ASC Topic 450. *See id.* In the relevant contingencies standard, FASB defined “probable” to mean that “[t]he future event or events are likely to occur.” *See* Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*, ¶ 3(a). Although the standard does not assign percentages to this term, practitioners generally note that “probable” represents approximately a seventy percent chance or greater of occurrence. *See, e.g., A Roadmap to Accounting for Contingencies and Loss Recoveries*, at 21 (Deloitte 2019).

[13] *See* ASC 205-40-55-2 (using same list of adverse conditions as that used by PCAOB); ASC 205-40-50-6 (consideration of management plans).

[14] *See* AS 2415.12.

[15] *See* ASC 205-40-50-13 (requiring both footnote disclosure and “information that enables users of the financial statements to understand” three points: (i) the “[p]rincipal conditions or events that raise substantial doubt about the entity’s ability to continue as a going concern”; (ii) “[m]anagement’s evaluation of the significance of those conditions or events in relation to the entity’s ability to meet its

obligations”; and (iii) “[m]anagement’s plans that are intended to mitigate the conditions or events that raise substantial doubt about the entity’s ability to continue as a going concern”).

[16] Specifically, management’s disclosures must include (i) the “[p]rincipal conditions or events that raised substantial doubt about the entity’s ability to continue as a going concern (before consideration of management’s plans)”; (ii) “[m]anagement’s evaluation of the significance of those conditions or events in relation to the entity’s ability to meet its obligations”; and (iii) “[m]anagement’s plans that alleviated substantial doubt about the entity’s ability to continue as a going concern.” ASC 205-40-50-12.

[17] In adopting ASU 2014-15, FASB explicitly stated that it considered limiting the going-concern analysis to an annual exercise but elected to adopt a quarterly requirement instead, “to ensure that uncertainties about an entity’s ability to continue as a going concern were being evaluated comprehensively for each reporting period, and being reported timely in the financial statement footnotes.” ASU 2014-15, ¶ BC23.

[18] In the wake of FASB’s adoption of Subtopic 205-40, the PCAOB staff issued a release emphasizing that an issuer’s “determination that no disclosure is required under [applicable accounting principles] is not conclusive as to whether an explanatory paragraph is required” under PCAOB standards. PCAOB Staff Audit Practice Alert No. 13, *Matters Related to the Auditor’s Consideration of a Company’s Ability to Continue as a Going Concern* (Sept. 22, 2014). The exception to the principle in AS 2415 that the auditor is in a proactive rather than reactive position in conducting its annual assessment is that, should the entity determine that substantial doubt exists, then the auditor is required to assess the reasonableness of management’s disclosures on that point. *See* AS 2415.10-.11.

[19] *See* AS 4105.21.

[20] *See* ASC 205-40-55-2; AS 2415.06.

[21] ASC 205-40-50-3.

[22] AS 2415.02.

[23] AS 2415.04.

[24] ASC 205-40-50-7.

[25] *See* ASC 205-40-50-8.

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

[27] AS 2415.08-.09.

[28] *See* AS 1105.29, *Audit Evidence* (requiring auditor to perform procedures to address any inconsistency or lack of reliability in the audit evidence it obtains). As an example, the SEC in the



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*Reinhart* matter (see *infra* note 33) considered in connection with Ms. Reinhart’s going-concern analysis the predecessor standard to AS 1105, which likewise directs an auditor to “consider relevant evidential matter regardless of whether it appears to corroborate or to contradict the assertions in the financial statements.” AU 326.25, *Evidential Matter*. In its order, the SEC appeared to assume that Ms. Reinhart was required to consider inconsistent audit evidence as well as confirmatory evidence when assessing the issuer’s ability to continue as a going concern. See, e.g., *In the Matter of the Application of Cynthia C. Reinhart, CPA*, SEC Rel. No. 85964 at 19 n.38 (May 29, 2019).

[29] See AS 4101, *Responsibilities Regarding Filings Under Federal Securities Statutes*.

[30] Compare AS 2415.02 (“date of the financial statements being audited”) to ASC 205-40-50-1 (“date that the financial statements are issued”).

[31] ASU 2014-15, ¶ BC28.

[32] AS 2415.02 (emphasis added).

[33] See generally SEC Rel. No. 85964.

[34] See *id.* at 8 (use of subsequent balance-sheet date for analysis); 8-11 (evidence concerning liquidity arising during subsequent period after balance-sheet date).

[35] See, e.g., John H. Eickemeyer, “The Concerns with Going Concern,” *The CPA Journal* (Jan. 2016).



*Gibson Dunn’s lawyers are available to assist with any questions you may have regarding developments related to the COVID-19 pandemic. For additional information, please contact any member of the firm’s Securities Regulation and Corporate Governance or Business Restructuring and Reorganization practice groups, the Gibson Dunn lawyer with whom you usually work, or the following authors:*

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