Recommendation of the Investor-as-Owner Subcommittee of the SEC Investor Advisory Committee
COVID-19 Challenges to Going Concern Opinions and Audit/Controls Assessments

(May 29, 2020)

COVID-19 has created unprecedented challenges confronting every level of the national economy. The negative shocks and financial downturn caused by this health crisis have already driven firms into bankruptcy, and a larger number have cut dividends, reduced pay, and drawn down on lines of credit. Companies have been forced to adapt to uncertain working conditions created by not only COVID itself, but the broader impact on the economy from self-imposed responses to COVID's health risks, as well as stay-at-home orders, which together have resulted in the closing of non-essential businesses, widespread work-from-home arrangements, and sharply reduced travel and trade.

Already, the Commission has taken a number of positive steps to guide and assist investors, companies, and the markets to cope with these ongoing challenges. This brief recommendation suggests two additional areas where we believe the Commission can provide additional useful guidance and engage in targeted action to benefit investors in this historically catastrophic environment. Specifically, we recommend that the Commission:

- **Remind investors and issuers about "going concern" disclosure obligations.** As more companies face the possibility of bankruptcy due to the pandemic, issuers can be usefully reminded that under existing FASB standards issuers (and not just auditors) must inform investors not simply at the moment of insolvency or the filing of a bankruptcy, but in advance, should it become "probable" that their businesses are no longer "going concerns."[1] In addition, PCAOB's audit standards require audit firms to qualify audit opinions if there is a "substantial doubt" about the going concern status of an audit client. Companies should also be reminded to speak consistently and clearly with retail and institutional investors alike, in both SEC filings and other public statements.

- **Guide investors and issuers in confronting challenges in conducting audit and controls assessments.** Companies are adapting to never-before-seen working conditions as employees and operations are moved off-site. These novel conditions pose novel opportunities for fraud, unauthorized use of funds, and financial misstatement. The same new reality faces auditors in conducting audit or controls assessments. The Commission can play a useful role in reminding issuers and investors about their existing obligations in maintaining adequate control systems, as well as their disclosure obligations if material weaknesses in control systems emerge, guide them in their obligation to continually assess controls in light of new work patterns, and engage with the PCAOB, audit firms, and others about best practices in the current environment.

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[1] Financial Accounting Standards Board, *Accounting Standards Update (ASU) 2014-15, Subtopic 2015-40, Presentation of Financial Statements – Going Concern – Disclosure of Uncertainties about an Entity's Ability to Continue as Going Concern*, at https://www.fasb.org/resources/ccurl/599/128/ASU%202014-15.pdf. This guidance became effective in 2016.

Brief Explanation of Recommendations

1. Remind investors and issuers about "going concern" disclosure obligations.

A number of companies have already entered bankruptcy as a result of the pandemic, and more are almost certain to do so, as bankruptcy rates have historically been closely correlated with unemployment, which has already reached levels not seen since the Great Depression. Investors and companies should be clear about existing disclosure obligations regarding companies' going concern status.

Specifically, not only do auditors have obligations to evaluate companies' going concern status, but companies themselves have disclosure obligations under the relevant Financial Accounting Standards Board (FASB) standard. The standard requires disclosure by an issuer if "it is ***probable*** that the entity will be unable to meet its obligations" in the following year.[2] FASB defines "probable" to mean "likely to occur."[3] Disclosures are required in financial statements prepared for both annual and interim reporting periods. Given the distress imposed by the pandemic, and given that the economy is likely to continue to decline for at least the next three to six months, companies would do well to consider this obligation if they are finding it necessary to cut dividends, sell equity, draw down on credit lines, or cut executive compensation.[4]

While the FASB uses the "probable" standard for companies, the Public Company Accounting Oversight Board (PCAOB) uses a lower standard for auditors issuing their reports. Specifically, PCAOB requires an auditor evaluate whether there is "***substantial doubt***" about the entity's ability to continue as a going concern for the following year. [5] Auditors are directed to consider if the results of the audit in aggregate "indicate there could be substantial doubt."[6] This standard is widely understood to mean something likely, but less than probable. Companies and investors should anticipate the application of this audit standard as they approach the issuance of an audit report.

2. Guide investors and issuers in confronting challenges in conducting audit and controls assessments.

The pandemic has also created never-before-seen challenges for companies as business operations have been forced off-site to protect employees or to respond to employees' rational health concerns, or as a result of having to close non-essential businesses or respond to governmental stay-at-home orders. Companies have had to adapt and develop what are effectively new payment processes and

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[2] See note 1 above.

[3] Id.

[4] See, e.g., Andrew Y. Chen and Jie Yang, Financing Concerns in April 2020 Appear Worse than in 2008 Based on Earnings Calls, Working Paper (May 4, 2020), at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3592929.

[5] Public Company Accounting Oversight Board (PCAOB). (2016). *Consideration on an Entity's Ability to Continue as a Going Concern* (AS 2415), at https://pcaobus.org/Standards/Auditing/Pages/AS2415.aspx. The SEC also has guidance on such disclosures in its Financial Reporting Manual. See SEC Financial Reporting Manual section 4230.1, at https://www.sec.gov/corpfin/cf-manual.

[6] Id.

other financial "systems" (loosely speaking, including for example, having employees initiate payments from home computers in a way that they previously would not have done). These changes could create new and unidentified weaknesses in companies' financial and disclosure controls, as well as increase risk of fraud, misuse of funds, or material misstatements.

Compounding these risks is the probability that they will be much harder to detect as the crisis prevents traditional on-site audit or controls assessment work. It is universally agreed upon that such work is best done in-person where the individual is able to directly observe business operations and experience workplace culture and interviews can reflect body language and other non-verbal cues. While some work (e.g., reconciliations of bills) can be done remotely with only a loss of efficiency, some work may be impossible to do in the current environment, creating risks that weaknesses, fraud, or misstatements may go undetected by the operation of normal control functions.

In light of these exceptional circumstances, the Commission should actively engage with relevant parties – companies, investors, auditors, the PCAOB, and its own inspections staff – to explore the specific ways in which distance work may manifest in new risks, and use that engagement to develop or encourage the development of guidance concerning best practices in responding to the pandemic. The Commission's Chief Accountant and Division of Corporation Finance would be particularly well positioned to interview officials from issuers and auditors about how they are attempting to identify any new weaknesses. Further, the Commission's Division of Enforcement and Office of Compliance Inspections and Examinations should be mindful of these risks in carrying out their roles in overseeing brokers and advisors, and in responding to reports of fraud or misstatement.