

# Going concern: Management's evaluation during coronavirus pandemic

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## Introduction

Due to the widespread and significant impact to businesses resulting from the coronavirus, entities should consider the impact of the global health pandemic on their operations. Entities will need to evaluate the impact to operations (and, therefore, their ability to meet their obligations) from location and production closures, decreased demand for products or services, difficulties obtaining products or services, an inability to collect from customers on outstanding receivables, the ability to access additional financing because of liquidity issues, and other relevant factors. The results of these evaluations may impact the recognition and measurement of amounts in the financial statements including assets such as goodwill, receivables, and inventory, as well as the disclosures required that may include amongst others, risks and uncertainties and the entity's ability to continue as a going concern. In those cases where liquidation is imminent, even the basis of reporting will be impacted.

Under U.S. generally accepted accounting principles (GAAP), financial statements are generally prepared on the assumption that the entity will continue as a going concern. However, in the current environment there may be conditions or events that raise substantial doubt about that assumption. In those situations, assuming liquidation is not imminent,<sup>1</sup> financial statements should continue to be prepared under the going concern basis of accounting, but entities may need to disclose additional information about the relevant conditions and events. The primary source of authoritative guidance under U.S. GAAP related to uncertainties about an entity's ability to continue as a going concern is ASC 205-40, *Presentation of Financial Statements – Going Concern*.

This white paper will assist entities in evaluating whether there is substantial doubt about an entity's ability to continue as a going concern and preparing the related footnote disclosures.

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<sup>1</sup> If and when an entity's liquidation becomes imminent, financial statements should be prepared under the liquidation basis of accounting in accordance with ASC 205-30, *Presentation of Financial Statements – Liquidation Basis of Accounting*.

## Assessing going concern

### Evaluating conditions and events

As part of the process of preparing annual or interim financial statements, an entity's management is required to evaluate whether there are conditions or events that raise substantial doubt about the entity's ability to continue as a going concern. According to ASC 205, substantial doubt about an entity's ability to continue as a going concern exists 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 (or within one year after the date that the financial statements are available to be issued when applicable)."

Given the current economic environment created by the coronavirus, management should consider whether impacts on an entity's business, such as a planned or forced shutdown, government imposed restrictions, reduced customer demand or an inability to collect receivables from customers, raise substantial doubt about an entity's ability to continue to meet its obligations as they become due.

There is not an automatic presumption that all entities have had their operations impacted such that there are adverse conditions and factors that raise substantial doubt about the ability to continue as a going concern. The impact of coronavirus may vary based on the entity's industry. Some industries such as gaming, retail, travel, hospitality, industrial manufacturing, oil, and gas and other service businesses may be significantly impacted by closures of business activities and slowdown in demand for products, in addition to other factors. Conversely, other industries such as grocery, consumer staples and defense may not be as significantly impacted in current conditions. However, entities in these industries may need to consider collections of receivables for products sold and future declines in sales based on consumers currently purchasing excess supplies.

When evaluating an entity's ability to continue as a going concern, management should consider conditions and events that are known and reasonably knowable at the date that the financial statements are issued (or available to be issued). As part of this evaluation, management should consider both quantitative and qualitative information about the entity's current financial condition, its obligations due or anticipated within the next year and the funds necessary to maintain operations for at least one year after the date that the financial statements are issued. ASC 205-40-55-2 contains examples of adverse conditions and events that may raise substantial doubt about an entity's ability to continue as a going concern, many of which are likely prevalent in the current economic environment, and include (in part) negative financial trends or ratios, defaulting on debt (or the need to restructure to avoid default), the loss of a principal customer or supplier and external matters that jeopardize operations. All relevant conditions and events should be considered in the aggregate, rather than concluding based on the existence or absence of one or more conditions or events.

An entity with debt coming due in the coming year will need to give consideration to its ability to refinance or otherwise repay such debt.

Subjective acceleration clauses may also be relevant to management's evaluation of whether substantial doubt exists. Entities should evaluate their debt agreements for subjective acceleration clauses based on all relevant factors, including the impact of the coronavirus to their industry and operations, as well as industry prospects and changes to economic factors.

The current economic situation creates difficulties for many entities to project future results from operations and other factors for the upcoming twelve months with any degree of certainty. However, based on the currently available knowledge, management should evaluate what it believes to be a reasonable projection. This may include probability weighting for different outcomes of future events (e.g., return to business operations in June, compared to July, or a later date).

The initial evaluation should not factor in management's plans to mitigate the effect of the events or conditions casting doubt on the entity's ability to continue as a going concern, unless those plans have been fully implemented as of the issuance date of the financial statements. In other words, even if management has plans to raise capital, borrow money, restructure debt or dispose of an asset, which they believe will alleviate any doubt about their ability to continue as a going concern, if those plans have been approved but have not been fully implemented as of the date that the financial statements are issued the entity will still be required to comply with the additional disclosure requirements discussed later in this white paper.

The going concern evaluation is performed at the reporting entity level; however, the impact of parent company activities, including debt covenant violations, may give rise to adverse conditions and factors the subsidiary entity should evaluate. The impact on the subsidiary entity depends on the legal relationship between the parent entity and the subsidiary entity related to the debt, as well as the ownership structure of the entities. For instance, a subsidiary's guarantee of the parent's debt may require an evaluation of the subsidiary's obligation to satisfy that debt obligation if it were probable to become callable during the period under evaluation for going concern.

### **Considering management's plans**

When conditions or events that raise substantial doubt about an entity's ability to continue as a going concern are identified, management should consider whether its plans will alleviate the substantial doubt. The mitigating effect of management's plans should be considered only to the extent that (1) it is probable that the plans will be effectively implemented and, if so, (2) it is probable that the plans, when implemented, will mitigate the conditions or events that led to the substantial doubt about the entity's ability to continue as a going concern.

To meet the first condition, management must consider whether it is probable that management's plans will be effectively implemented within one year after the date that the financial statements are issued. To be considered probable of being effectively implemented, the plans generally must be approved by those with the requisite authority prior to the issuance of the financial statements. Additionally, the feasibility of implementation in light of an entity's specific facts and circumstances must also be considered.

ASC 205-40-55-3 includes examples of plans that management may implement as well as the types of information that management should consider when evaluating the feasibility of the plans. For example, if management plans to implement cost saving measures to mitigate the effect of decreased revenue as a result of the coronavirus pandemic, management should consider the feasibility of plans to reduce overhead or administrative expenditures rapidly enough to counteract the more immediate reduction in revenue.

If management's plans involve the consideration of available long-term financing in the form of debt, the entity should carefully review the related term sheet(s) to determine whether the debt may have to be repaid within one year after the financial statements are issued (or available to be issued), because, for example, the debt is due on demand or due upon failing to meet certain covenants.

In situations where it is probable in the future that debt covenants will be violated and the debt will become due or callable, management's plans should consider:

- a. The ability to obtain a waiver or modification of the covenants for the potential future violations covering the period under evaluation for going concern;
- b. The ability to enter into a forbearance agreement covering the period under evaluation for going concern; or
- c. The impact of including in its projections the full amount of debt becoming due at the date of the projected debt covenant violation. Any such executed waiver, modification or forbearance agreement,

taken together with any other management plans, may mitigate the severity of the adverse factors, but would still be disclosed in the financial statements.

Once management has determined that it is probable its plans will be implemented, it must then assess whether the plans will in fact mitigate the conditions or events that raise substantial doubt about an entity's ability to continue as a going concern. As part of this assessment, management will need to compare the expected magnitude and timing of the mitigating effect of its plans to the magnitude and timing of the relevant conditions or events.

When evaluating the mitigating effect of management's plans in the current environment, management may need to consider different factors than those previously necessary, such as:

- Whether historically based projections are reasonable to predict future results
- Whether access to capital from investors or lenders is impacted by the current environment
- In light of the uncertainty, the use of probability weighting for different outcomes including the timing of a return to business operations and changes in business operations due to the longer-term impacts of social distancing
- Impacts of government stimulus packages on future operations, including the entity's eligibility for receipt of such support (e.g., loans, grants, tax relief) and the timing of any such support

## Disclosure requirements

The required disclosures differ depending on whether or not management's plans alleviate the substantial doubt. See the flowchart below, which illustrates Financial Accounting Standards Board reporting requirements.

When conditions or events raise substantial doubt about an entity's ability to continue as a going concern, and the *substantial doubt is alleviated* as a result of management's plans, the following disclosures are required:

- Principal conditions or events that raised substantial doubt, before consideration of management's plans
- Management's evaluation of the significance of those conditions or events
- Management's plans that alleviated substantial doubt

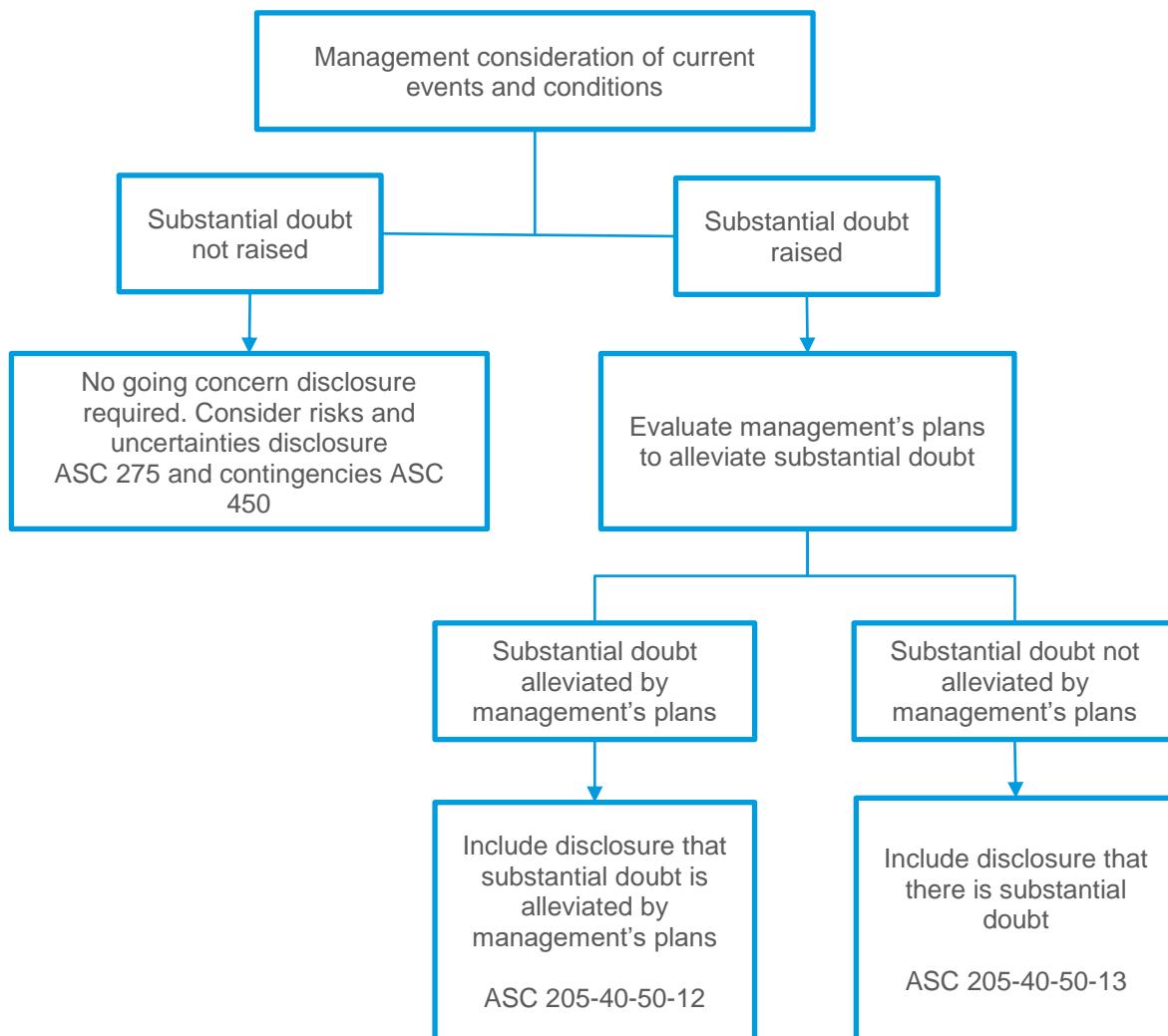
If conditions or events raise substantial doubt about an entity's ability to continue as a going concern, and *substantial doubt is not alleviated* by management's plans, the entity must include a statement in the footnotes indicating that there is substantial doubt about the entity's ability to continue as a going concern along with the following disclosures:

- Principal conditions or events that raise substantial doubt
- Management's evaluation of the significance of those conditions or events
- Management's plans that are intended to mitigate the conditions or events that gave rise to substantial doubt

These disclosures must continue to be included in both annual and interim reporting periods for as long as conditions or events continue to raise substantial doubt about an entity's ability to continue as a going concern. Furthermore, as additional information becomes available about the relevant conditions or events and about management's plans, the disclosures should become more extensive and explain how conditions or events have changed between reporting periods.

In the reporting period in which management determines that substantial doubt about the entity's ability to continue as a going concern no longer exists, the entity should disclose how the relevant conditions or events that raised substantial doubt were resolved.

**Flowchart: Decision tree related to coronavirus reporting considerations  
(assuming liquidation is not imminent)**



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