UNIVERSITY OF RICHMOND

# ROBINS School of Business

# Going Concern Audit Opinions in the Age of Covid-19

## Some Thoughts


## Marshall A. Geiger

University of Richmond
ROBINS School of Business

- *First, let's take a quick walk down memory lane . . .*

# Year was 2019 – a great year!

- World stock markets were uniformly performing pretty well
- General global economic outlook was fairly bright (of course there was still the Brexit thing to get resolved, and US – China trade tensions, etc.)
- Going Concern Modified Opinions (GCOs) from auditors in the U.S. was at a 10-year low, reflecting relative broad business financial health (Audit Analytics 2020)

# Then we entered 2020 – Yikes!

After a smooth start, things got messy quick!

Here are some selected headlines from the *WSJ/CFO Journal* or *Financial Times*

(undoubtedly from my US-biased perspective)

10 Feb – Smaller US firms struggle to get workers despite strong job market

13 Feb – Global central bankers adopt cautious outlook on Coronavirus

14 Feb – White House proposes to fold PCAOB into SEC

25 Feb – Global stock markets slide as virus spreads in Europe

4 Mar – Death toll in US rises to 11 as virus spreads in California & New York

13 Mar – Dow suffers its worst day since 1987

24 Mar – Companies like FedEx, GE, Starbucks, American Eagle & Zillow withdraw guidance due to uncertainties surrounding Covid-19

27 Mar – US passes **$2.2T** CARES Act for C-19

5 Apr – Boris Johnson admitted to hospital w/C-19

9 Apr – SEC urges companies to be transparent in their Covid-19 disclosures

15 Apr – World economy forecast to contract 3.0% in 2020; US personal tax filing due date moved to 15 July

16 Apr – Citigroup increases loan loss reserve from $278M to $4.92B --> an increase of ~**1,700%** !

17 Apr – US jobless claims now at 22M in 4th week of shutdown

21 Apr –US crude oil price goes negative for 1st time

22 Apr – over 18M workers in Europe idled

27 Apr – France, Spain, Italy & US move to ease lockdown restrictions; B. Johnson's first day back

28 Apr – HSBC profits are half normal and loan loss provisions increase by 400%

30 Apr – US economy shrank 4.8% in Q1 of 2020

- Royal Dutch Shell cuts dividend for 1st time since WWII

4 May – European & US banks book >$50B in loan losses in Q1 of 2020

- Exxon/Mobil posts first quarterly loss in 30 years

5 May – Global deaths from Covid-19 top 250,000

6 May – *WSJ* article "Going Concern opinions may be poised for a comeback"

7 May – European Com. estimates contraction at 7.75% of GDP so far for 2020 (it was 4.5% in GFC)

13 May – Fed. Chair Powell says more measures may be necessary to prevent L-T damage.

18 May – India extends lockdown; Finance Minister suspends bankruptcy cases for up to 1 year

22 May – Financial statement fraud risk increases due to Covid-19 (ICFR disruptions & mkt. pressure)

28 May – US jobless claims hit 40 million

1 Jun – UK banks warn up to 50% of C-19 loans may default, with hundreds of thousands of failed businesses

8 Jun – Germany reports historic 18% tumble in output in April – largest on record

9 Jun – World Bank expects global economy to shrink by 5.2%

- US Fed expects 6.5% US contraction for 2020
- US Stocks erase 2020 losses (Nasdaq>10,000 1st)

11 Jun – Global stocks fall amid gloomy employment outlook

12 Jun – UK economy shrinks by 20% in April

15 Jun – Global equity markets sink amid surge of Covid-19 cases in US and China

16 Jun – Global equity markets rally on hopes of fresh US stimulus measures; US retail sales up 18% in May

17 Jun - Bank of England forecast to unleash at least £100B in extra stimulus; UK public debt>100% of GDP

18 Jun – >45M in US have filed for unemployment

***Ahhh, the memories....***

# So, what will the immediate business future look like? And what will the shape of the recovery look like?

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# What do the experts think?

**Mike Wilson, Morgan Stanley's chief investment officer** (FT 3 June):

"Historically, economies frequently experience a V-shaped recovery after a recession. The severity of this particular recession, combined with the unprecedented policy response, makes it unlikely we will see anything but a V-shaped recovery this time."

# **Erik Nielsen, UniCredit's chief global economist** (FT 3 June, same article):

"Attempting to forecast the economic effects of the lockdown is truly a fool's game. Never before have we seen a man-made recession of this scale, nor have we seen policy responses of this magnitude to cushion the impact on people's livelihood. On balance, however, I expect the biggest peacetime recession in almost 100 years."

*These are just illustrative of the disparity of opinion among the "experts" that live and breathe this stuff!*

So, what will business look like after the "new normal" is established?

And what does this mean for auditor's and their opinions with respect to going concern uncertainty?

Looking at the plethora of new COVID-19 practice guidance issued (sometimes more than once!) by just about every public & private auditor regulatory body, as well as association of public auditors on earth, evidently it means …

The ***exact same thing*** <u>**after**</u> COVID-19 as it did <u>**before**</u> COVID-19!

# There is essentially nothing "new" as far as regulations, standards or the responsibility of auditors in the COVID-19 guidance that was not in place prior to the COVID-19 pandemic.*

*With the exception of deferring the implementation of some already adopted auditing & financial reporting standards.

This is a good thing! It indicates that we believe the fundamental underlying approach to going concern issues is sound – even when "stress tested"!

The "new" guidance reminds us to be diligent auditors and follow the existing standards – and that this is especially difficult right now, but the world is very interested and will be watching.

However, that I still find most of the guidance helpful as it

- focuses discussion on the difficult issues involved in determining whether a GCO is appropriate
- provides more explicit detailed discussion of audit evidence to consider when deciding the appropriate reporting on going concern uncertainties
- is helpful both in determining the appropriateness of a GCO, as well as appropriate use and disclosure in the accompanying KAMs/CAMs and EOM paragraphs

I also find it interesting that the ICAEW in the U.K. issued “guidance” for **investors** on how to interpret auditor GCOs and related disclosures, especially with the expected increase in the number of GCOs, and going-concern-related KAMs/CAMs and EOM paragraphs investors are likely to encounter.

(https://www.icaew.com/insights/viewpoints-on-the-news/2020/apr-2020/coronavirus-understanding-audit-reports)

# My favorite quote from the pandemic -

When responding to questions regarding the country's response to the pandemic, Dutch Prime Minister Mark Rutte replied that:

1) All decisions have been ***made with the scientific insights available at that moment***.

2) "***In crises like this, you have to make 100 percent of the decisions with 50 percent of the knowledge, and bear the consequences***."

12 March in *NL Times*

https://nltimes.nl/2020/03/12/everyone-stay-home-sick-many-events-banned-dutch-government-tightens-coronavirus-rules

Isn’t this EXACTLY the issue auditors are faced with regarding going-concern uncertainties!

1) You base decisions on known facts and circumstances at the time.

2) You have to make 100% of the decision with only 50% (or less) knowledge of the course, or even possibility, of future events.

3) You bear the consequences of the decision.

Even if a client company's business seems to be going well, what do you do:

- When they radically change business models?
- To assess their preparation for future business disruptions?
- To ensure properly recorded financial statements - with all the required estimates and value analyses?
- To look past the immediate 2-3 months all the way to a year out?
- To decide <u>when</u> to do the "*going concern review*"?
- To help clients properly account for any government aid received?

These (and a host of others) are not trivial issues.

Neither is deciding where clients fall on the going-concern uncertainty disclosure "spectrum" -

- no mention
- include in KAM/CAM
- include in explanatory paragraph (EOM)
- include in explanatory paragraph and modify opinion (GCO)
- qualify the opinion / issue an adverse opinion
- disclaim an opinion

These are all difficult issues and there are no easy answers.

As a researcher, and as practitioners, the Covid-19 pandemic poses a host of interesting and practical research questions for GCOs (and other areas!).

Per *AuditAnalytics* – as of 15 June, there were 47 US companies that received a GCO on their 2020 y-e financial statements (i.e., 1 Jan – 31 Mar).

- 30 of those firms received GCOs in 2019
- 17 firms received clean opinions in 2019
- This equates to ~36% "new" GCOs in 2020 already.

This compares to a 9-year average of ~23% "new" GCOs (*AuditAnalytics 2020*).

# Covid-19-Related GCO Research Questions

- Prior research has generally found that an increase in GCO rates increases type I “error” rates without much decrease in type II “error” rates.

***Q***: So, will the inevitable increase in GCOs due to the pandemic result in a similar pattern?

Or will there simply be more business failures in the next few years leading to a decrease in type II “error” rates?

Also, how does one assess the accuracy of 2019 audit reports? Can the non-GCOs in 2019 for failed businesses in 2020 be considered “type II errors”?

- Will GCOs be "overused," possibly as a way to limit legal liability?
- Will GCOs be "underused" in hope of reducing the "self-fulfilling prophecy?"
- In arriving at the GCO decision, will the same audit evidence be obtained and evaluated? If not, what is added and removed? And will that evidence get the same weight in GCO decisions as before?
- In essence, do the former "GCO decision models" hold in the pandemic, or post-pandemic period?

- Do audit firms change their internal processes for GCO evaluation? If so, how? Are these short-term or long-term changes?
- What specific additional work, if any, do auditors require of their clients to support evidence of going concern viability?
- How do auditors use KAMs/CAMs to report going concern uncertainties during the pandemic? Do these disclosures differ compared to the pre-/post-pandemic period?

- Do auditors issue more qualified opinions or disclaimers of opinion related to issues associated with going concern uncertainties during the pandemic?
- How often are going concern uncertainties mentioned in the <u>interim financial statements and review reports</u>? How does this compare to pre-/post-pandemic periods?
- How are GCOs related to specific financial statement items (i.e., intangibles, CFO, cash %, leverage ratios, FV estimates, Goodwill impairments, etc.)

- How are GCOs related to non-financial statement items?
  - ownership type (institutional investors/family/etc)
  - institutional setting (country/legal environ/etc)
  - supply-chain resilience
  - outside guarantors
  - industry differences

- **<u>Importantly, how do auditor characteristics:</u>**

- experience levels (partner, team)
- industry expertise (partner, team, office)
- tenure with the client (partner, team, office)
- perceptions of the self-fulfilling proph. (partner, team)
- willingness to challenge client management/professional skepticism (partner, team)
- Confidence (partner, team)
- Other traits / characteristics ….

manifest in differences in evidence evaluation, GCO <u>issuance rates</u> and <u>“error” rates</u> during the pandemic compared to the pre-/post-pandemic period?

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# Most importantly, what are the "new" or "heightened" issues faced by auditors actually making GCO decisions during these times?

**What do you think?**

- **???**

Please post your issues/comments in the chat box and/or send them to me at mgeiger@richmond.edu

# That's enough!

## Dank u zeer!


Marshall Geiger – mgeiger@richmond.edu

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