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COVID-19 ECONOMIC FALLOUT HIGHLIGHTS IMPAIRMENT AND GOING CONCERN ISSUES

By Don Carpenter, MSAcc/CPA

The economy began 2020 at a breakneck pace, with unemployment at record lows and the major stock indices at record highs. Everything pointed to a banner year until the Covid-19 virus put the brakes on "business as usual."

Some businesses such as many retailers had to temporarily close completely while others like the airline industry have seen unprecedented reductions in demand. Commodity prices have plummeted, with oversupply and consumer spending no longer fueling robust demand.

It's unclear at this point what the longer-term implications of this pandemic-driven recession will be. But in the short term, the prevailing economic conditions require that companies and their auditors review both impairment and going concern guidance to determine what adjustments to financial statements or disclosure might be required.

FAS 121 requires that goodwill and other long-lived assets be tested annually for potential impairment. However, if a triggering event occurs, interim period testing may be necessary. A triggering event is any change in facts or circumstances that could affect the fair value of the asset under review. Events such as loss of a major customer, change in law or increased competition are examples of a triggering event. Once a triggering event has been identified, impairment testing is accelerated.

In addition, Accounting Standards Update (ASU) No. 2011-08 allows companies to conduct qualitative analysis in lieu of quantitative cash flow modeling for impairment testing of goodwill. ASU No. 2012-02 extended qualitative analysis to other long-lived assets. The intent of the ASUs was to avoid costly analytical modeling when conditions had not changed sufficiently to call into question prior determinations of fair value.

But given the dramatic change in economic conditions, companies should consider whether they can rely on the qualitative approach for their analysis. In addition, if annual testing does not occur until later in the calendar year, a determination as to whether current prevailing

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circumstances constitute a triggering event that necessitates an accelerated testing schedule may be necessary.

These issues are particularly relevant to businesses that rely heavily on commodity prices for profitability, such as oil. As of the date of writing this article, oil prices have fallen to below $30 a barrel and the forward curve has the price staying below $40 a barrel for at least the next two years. The guidance does not allow affected companies to take a wait and see approach in hopes that prices will recover before the annually scheduled testing cycle comes around. Further, relying on the qualitative approach will be difficult given the marked change in economic conditions.

In a similar vein, the current economic conditions may increase the disclosures required under ASU 2014-15 with regard to the going concern standard. The ASU requires management to perform an assessment of a business's ability to continue as a going concern for at least one year from the date financial statements are issued. Additional disclosure is required if the assessment raises "substantial doubt" about the operation's ability to continue as a going concern.

Substantial doubt exists when facts and circumstances considered in their entirety indicate it is probable that an entity will be unable to meet its obligations as they become due over the next year. The standard gives several examples of events that may create doubt:

- Negative financial trends, such as recurring operating losses, working capital deficiencies or negative operating cash flows;
- Denial of trade credit by suppliers, default on loans or arrearages on dividends;
- Work stoppages or the need to significantly revise operations.

Under AU Section 341, the Public Company Accounting Oversight Board (PCAOB) requires the company's auditors to independently assess whether substantial doubt exists as to the viability of the business over the next 12 months. If the auditors believe that there is substantial doubt, they are required to review management's plans and determine the likelihood that the plans can be effectively implemented. Such plans can include actions such as:

- Plans to dispose of assets to increase liquidity;
- Plans to borrow from existing lines of credit or the likelihood of accessing new sources of financing;
- Plans to delay expenditures;
- Plans and ability to increase equity.

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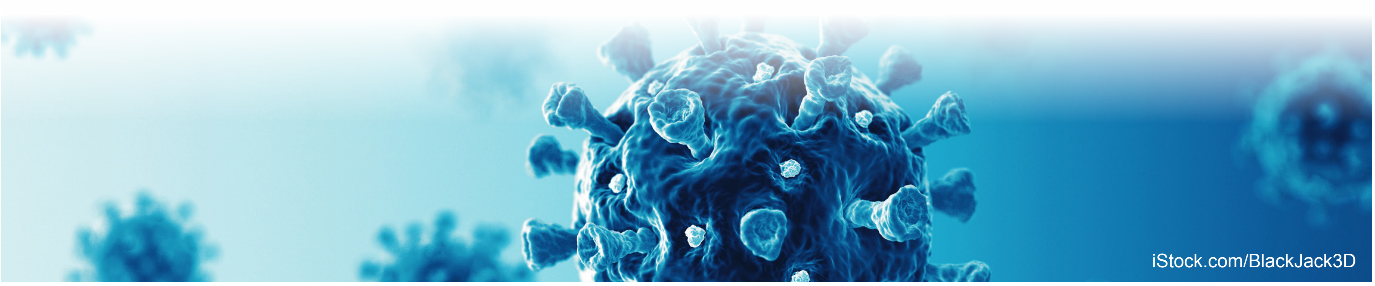
The outcome of the going concern assessment has implications for both financial statement disclosures and the auditor's report.

If the substantial doubt as to going concern is adequately addressed by management's plan, disclosure should be made regarding the conditions that led to the substantial doubt assessment, management's evaluation of the circumstances and its plans to alleviate the concern. If substantial doubt remains, the disclosure above should be supplemented with a statement that there is "substantial doubt about the entity's ability to continue as a going concern."

If the auditor concludes that substantial doubt remains as to the entity's ability to continue as a going concern after reviewing management's plan, he/she must include a paragraph in the audit opinion explaining the circumstances and including a statement that is very similar to the one required in management's disclosure.

Given the dramatic impact on businesses across all spectrums of the economy, management, accounting departments and attest firms would be ill-advised to take a wait and see approach to these issues. Becoming familiar with the guidance on these matters and preparing documentation to support decisions is critical. And as always, open and honest dialogue between the company and its auditor will lead to better, more efficient conclusions on these very technical matters.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