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The New Pressures for Going-concern Warnings

The pandemic has added complexity to the assessment of an organization's ability to maintain operations.

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November 03, 2020

The purpose of a corporate board is to help management keep the organization going. That abstract idea has taken quite the concrete turn lately, with heightened attention over an organization's ability to continue as a going concern.

Historically, going-concern warnings were the domain of audit firms, which for years have had to evaluate whether there was substantial doubt about a company's ability to keep operating for the subsequent 12 months. Things began to get more complicated in 2017, with new accounting rules that required management to evaluate the company's ability to continue as a going concern — and if substantial doubt did exist, also to disclose what management planned to do about it.

Then came the coronavirus, straining businesses like never before. As the first crisis to arrive since those expanded duties for going-concern disclosure, it has left everyone — boards, senior executives, audit teams, and even regulators — grasping for precisely what to say.

"That's the real crux of the matter — how to assess going concern during a pandemic," says Stephen Masterson, who serves on the audit committee of ShelterBox USA and

runs his own technical accounting advisory business in California. “If there used to be one way that a going concern would be evaluated, now there are 10 times more ways to assess with a pandemic happening.”

First, Follow the Money

Research firm Audit Analytics identified 42 companies through mid-July whose audit opinions raised going-concern warnings and cited COVID-19 as one contributing factor. Some, such as J. Jill and Stein Mart — retailers with large physical operations, shut down thanks to the coronavirus — were unsurprising candidates. Others ranged from energy firms, to online retail, to finance, to life sciences.

What, specifically, was going the wrong way at those firms? Audit Analytics flagged several issues. Most common were operating losses and negative cash flow from operations. Debt maturity was another common problem, as were the need for additional financing and “absence of significant revenues.” Almost all of the firms Audit Analytics identified had more than one issue cited in the auditor’s opinion.

The common theme in all those factors is liquidity: whether the company has enough cash coming in the door, or already on hand, to keep paying the bills while management weathers the storm. So as boards and C-suites consider the organization’s ability to continue as a going concern, tracking liquidity metrics becomes an urgent priority.

For example, Masterson recommends assigning a financial analyst to manage a rolling liquidity forecast updated at least weekly, if not daily. That forecast should be shared with the CEO daily, and with the audit committee at least weekly.

His worry: Managing and forecasting liquidity is a job best suited to the corporate treasury department — which, beyond the Fortune 500, many organizations don’t have. “So a lot of companies do this a bit blindly,” he says.

A controller or chief accountant might be able to do the work, with assistance from the chief financial officer or perhaps even outside help. Then comes the next question: Will board directors understand what they’re reading? Considering how much other material directors have to digest, and that many directors hail from operations rather than finance backgrounds, the answer could well
be “no.”

"Somebody has to be able to show it and explain it to both the smartest person in the room and the most basic person in the room," Masterson says, "so that everyone knows what they need to know to manage, run, govern, and assess the company during a crisis."

Second, Come up With a Plan

There's another challenge here, too: reassessing strategic and operational risks to develop a plan that keeps the organization going for the long term. The coronavirus complicates that work as well, because it has introduced so many new risks that executives have never had to consider.

A formal annual risk assessment can be a reasonable place to start, but as Christine Smith, former chief audit executive at auto parts supplier Tenneco warns: "Is there something new that's a risk to the organization with COVID-19 that I didn't have before?"

Smith gives an example from Tenneco during the financial crisis of 2008. Until then, Tenneco hadn't considered its third parties to be significant financial risks — because what was the chance that two of the largest, most established auto manufacturers in the world would go bankrupt at the same time? But Chrysler and General Motors did exactly that in 2008.

"What's in your risk universe? Because certain things that were not a risk for you before may be a risk today," Smith says. Audit committees and management need to connect those expanded business risks to specific bad outcomes such as impairments of goodwill or intangible assets, which can hammer the balance sheet and earnings reports.

That raises yet more questions: What are your key performance indicators (KPIs) to monitor such triggering events? Are the KPIs that you historically use still suitable for these more uncertain times, or should you develop new KPIs better suited to the risk?

More broadly: What will the company do to address strategic challenges implicitly raised in going-concern warnings? After all, management's plans to alleviate that substantial doubt are part of the disclosure, too.

Masterson recommends that boards "look beyond the horizon" and devise long-term

survival strategies, “versus hand-strapping it with reserves and write-downs on the balance sheet to appease the auditors and regulators. Those things have to come in balance,” he says.

Where Internal Audit Can Help

Clearly audit committees and management need help when trying to determine the organization’s ability to continue as a going concern and what steps might remedy a precarious situation. Internal audit teams could help in several ways.

First, internal auditors should consider the company’s reliance on forecasting and scenario planning. They wouldn’t necessarily audit the forecasts that were created, Smith says, but they could examine the processes management uses to generate forecasts — perhaps examining issues of data accuracy or consistency; or reviewing treasury processes over debt agreements and management of leverage ratios.

Likewise, internal audit wouldn’t audit any strategic choices the company makes, but it could help management understand how to strengthen some business processes to improve cash flow or how some choices might have consequences for other parts of the enterprise. The internal auditor can be “an outside observer and listener to management,” Smith says, “and provide input there.”

Masterson says the same. Auditors — both internal and external — should provide input and feedback “all along the way,” he says. “If they only learn about what the auditor’s viewpoints are at the reporting date, that’s too late.”

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