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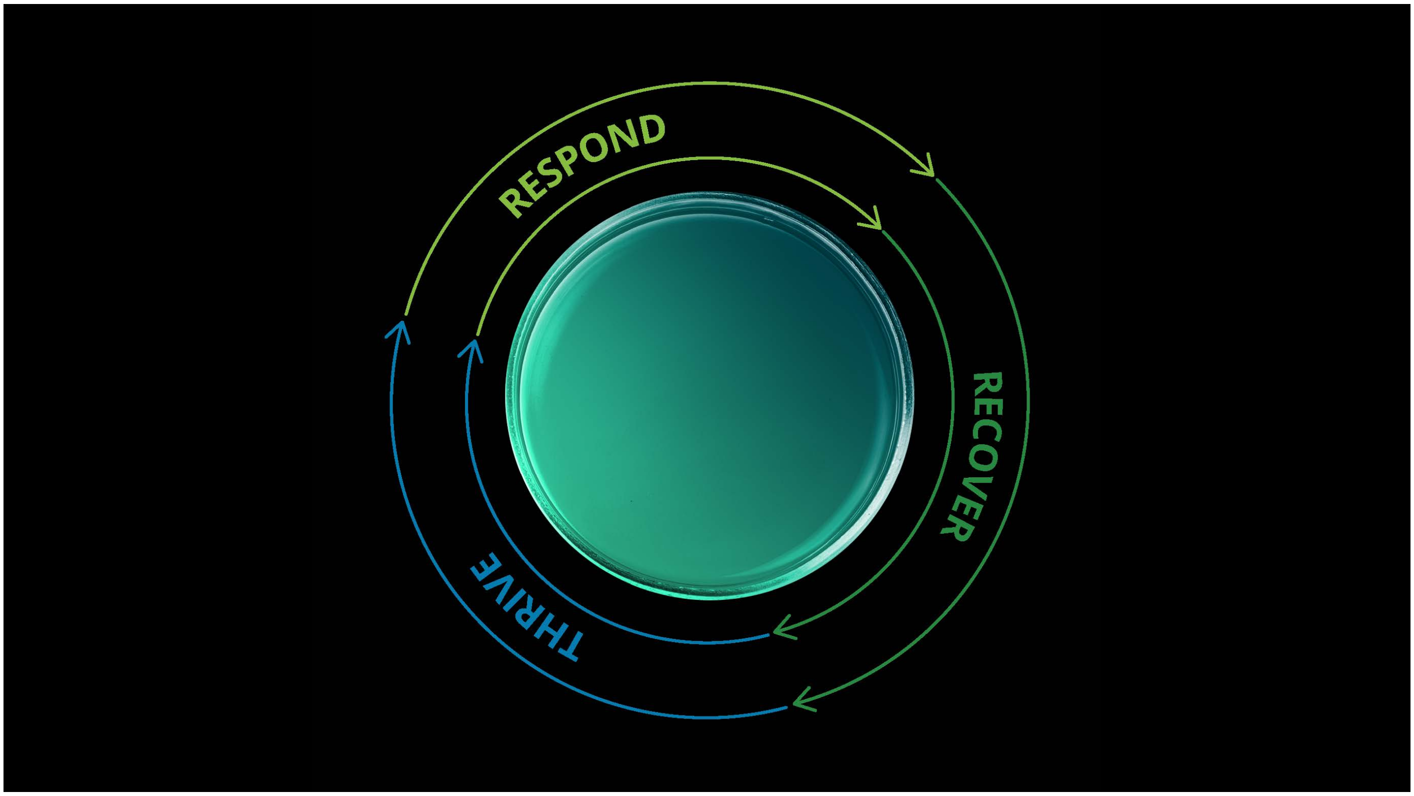


Financial Reporting Ecosystem

Transparency and reliability in the COVID-19 environment – they've never been more important than now

Tackling the current public health crisis is the clear #1 priority for everyone including governments around the world, and rightly so. Yet the effective economic shutdown is also having a profound impact on the world, creating particular issues for the financial markets.

COVID-19 has presented practical challenges that impact an entity's ability to produce timely, reliable, insightful information.

The financial reporting ecosystem is *necessarily irreducible* – meaning that each part is integral to the proper functioning of the others – and, therefore, the entire ecosystem must adapt *in concert* and *with speed*. Management, audit committees, regulators, policy-makers, standard-setters, investors, and auditors are in this *together*! It's important to remember that the purpose of the financial reporting ecosystem is to serve the public interest by enabling complete, accurate, transparent corporate financial disclosures.

Deloitte welcomes the public statements and guidance issued by many regulators that recognize the current uncertainties and emphasize the importance of high-quality, forward-looking corporate disclosures. Importantly, some regulators have conveyed that good faith attempts to provide investors and other market participants with appropriately framed forward-looking information should not be second-guessed (see Appendix).

Statements like these can instill companies with comfort that when today's disclosures are judged in the future, their good faith and robust disclosure based on what is known now, will not be judged more harshly than necessary. Said differently, what happens in the future is likely to be different to what any company can foretell or

"We appreciate that in many cases actual financial and operational results may differ substantially from what would now appear to be reasonable estimates.

Given the uncertainty in our current business environment, **we would not expect to second guess good faith attempts to provide investors and other market participants appropriately framed forward-looking information."**

US SEC Chairman Clayton
April 2020 Public statement

speculate today, even with the best tools and judgment. Public acknowledgment by regulators now bestows a welcome level of surety to companies and auditors alike. Exercising judgment consistent with relevant auditing and accounting standards in the COVID-19 environment is complex, and the story of COVID-19's impact on financial markets will not be complete if told from the future alone.

All stakeholders of the financial reporting ecosystem must exercise significant judgment in this unprecedented and uncertain environment – governments, when projecting the length of closures; bankers, when deciding if a loan can be repaid in full; management, when evaluating if a company can continue operating as going concern; auditors, when assessing these judgments, and investors, when analyzing the available financial information in light of these unprecedented uncertainties.

Deloitte seeks to raise awareness about the areas that pose challenges and require *more scrutiny, context-specific judgment, and increased documentation*[1]. There is benefit to the public from various financial reporting ecosystem stakeholders raising awareness about these issues; the public will gain more clarity about the responsibilities of audit committees, companies, auditors, and other stakeholders.

Going concern

Availability of government funding, uncertainties around duration of closures and stay-at-home orders, future market and consumer behaviors, and probability of different outcomes when developing estimates are critical assumptions made by entities during going concern assessments. Entities' management has responsibility to appropriately assess going concern and disclose substantial doubt and material uncertainty when it exists. Evaluating the audited entity's assessment of the appropriateness of the going concern basis of accounting (and related disclosures) is a requirement of the audit that may be significantly affected by the current circumstances.

Although the requirements under different accounting and regulatory frameworks may vary, in general financial statements are prepared on a going concern basis unless management intends either to liquidate the entity or to cease trading. Entities need to consider whether, in their specific circumstances, they have the ability to continue as a going concern for at least, but not limited to, 12 months from the reporting date. Management's assessment of the entity's ability to continue as a going concern involves making a judgement, at a particular point in time, about inherently uncertain future outcomes of events or conditions.

This will require an entity to consider, among other things, (1) the extent of operational disruption; (2) potential diminished demand for products or services; (3) contractual obligations due or anticipated within one year; (4) potential liquidity and working capital shortfalls; and (5) access to existing sources of capital (e.g., available line of credit, government aid). An entity can only base this assessment on information that is available as of the issuance date of the financial statements.

Impacts and challenges
(examples not all inclusive):

- It may be difficult for an entity to obtain a meaningful baseline economic forecast to develop estimated future cash flow scenarios that are the basis for the going concern assessment, including further plausible downside economic scenarios specific to the entity.
- Evaluating the degree of business disruption can be complex (e.g., will correlations from past consumer behavior and business practices apply after the crisis, or does this require a reassessment and recalibration of models used?).
- There is often a lag between a general announcement of government relief programs and the details behind the programs which will require subjective judgements about how to consider government programs in the going concern assessment.

[1] https://www2.deloitte.com/ae/en/pages/audit/articles/accounting-implications-of-COVID-19.html
https://www2.deloitte.com/us/en/pages/audit/articles/financial-reporting-considerations-related-to-covid-19-and-an-economic-downturn.html

In parallel, auditors will need to make an evaluation of the reasonableness of these management judgments. Thus, when accounts are prepared on a going concern basis, it does not guarantee that an entity will continue in business – and there is a great need for investors to understand this important fact. In the COVID-19 environment, clear disclosures of the assumptions used by management in making forward-looking judgements when evaluating the going concern are important to provide timely and transparent information to the capital markets. It is important not to “mask” previously existent financial challenges as an outcome of the “COVID” impact.

Regulators’ coordinated, consistent, visible commentary about the effects of COVID-19 on financial reporting is needed, especially related to clearly articulating the responsibilities of management, those charged with governance, and auditors. The regulators also have an important role in educating investors and the public regarding challenges – specifically challenges to making accounting estimates and going concern judgments presented by the current environment.

At Deloitte, we take our responsibilities to serve the capital markets and public interest very seriously. Accordingly, we are deeply committed to investing in capabilities and continuous improvement to deliver high-quality audit services.

Connect with us

If you would like to discuss Deloitte Global initiatives further, please contact **Wally Gregory,** Regulatory, Independence, and Conflicts Leader, Deloitte Global (wgregory@deloitte.com), **Jeff Kottkamp**, Audit & Assurance Quality Leader, Deloitte Global (jkottkamp@deloitte.com), or **Kat Sityar,** Managing Director, Deloitte Global (ksityar@deloitte.com).

Appendix

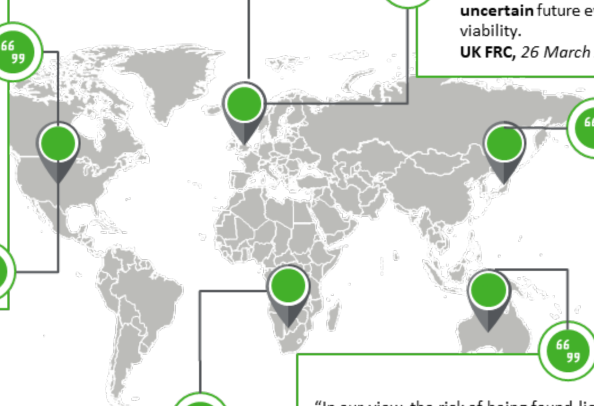
From podcast- April 2020: ….”it may be more difficult for an auditor to do some of the things that they would normally do to gain sufficient appropriate audit evidence to say that the accounts give a true and fair view…you may have a situation where an auditor has not been able to gain sufficient appropriate audit evidence because it's not possible to gather that evidence because of current limitations.”
UK FRC Mark Babington *24 April 2020* **-** *Acting Executive Director of Regulatory Standards*

"The FRC thinks it is likely that more companies will disclose "material uncertainties" to going concern in current circumstances. This term may not be widely understood. It refers to uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern. In other words, if boards identify possible events or scenarios (other than those with a remote probability of occurring) that could lead to corporate failure, then these should be disclosed. When identifying such events or scenarios, boards may take account of realistically possible mitigating responses open to them. Events could lead to corporate failure because of the scale of their adverse impact on the company and its ability to avoid liquidation or because of their timing……. In the absence of any consensus view of the future path of the COVID-19 pandemic and its impact on the economy, users cannot expect all companies to apply consistent assumptions when there is such uncertainty. This lack of consistency makes the need for full disclosure of judgements, assumptions and sensitive estimates significantly more important than usual."
UK FRC, *May 2020 Company Guidance*

Given the systemic uncertainties that currently exist, many boards will be less confident in stating that they have a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due over a period of assessment ("the viability statement" as required for compliance with the UK Corporate Governance Code). However, the FRC stresses the following points:

- Boards are required to have a "**reasonable expectation**" of the company's viability over the period of assessment – during the current emergency and unprecedented pace of change, **any reasonable level of expectation would naturally carry a much lower level of confidence.**
- Being clear on the company's specific circumstances and the **degree of uncertainty about the future is important information.**
- When presenting a company's viability statement, its board should draw attention to any qualifications or assumptions as necessary.
  In describing any qualifications to the statement, a board should describe **the limits of the predictions, the level of confidence with which they have been made and the uncertain** future events that could prove critical to viability.
  UK FRC, *26 March 2020 Guidance Update*

"Responsibilities of the Auditor
… However, as described in ISA 200, **the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for future events or conditions that may cause an entity to cease to continue as a going concern. The auditor cannot predict such future events or conditions. Accordingly, the absence of any reference to a material uncertainty about the entity's ability to continue as a going concern in an auditor's report cannot be viewed as a guarantee as to the entity's ability to continue as a going concern. "**
IAASB *15 January 2015*, *ISA 570 (Revised): Going Concern*



"Unless the certain assumptions made by the entity is clearly unreasonable, estimated amounts as a result of developing the best estimates would not be considered "errors", even when the estimated amounts turn out to be different from the subsequent results."
ASBJ *(Japan) 9 April 2020*

"Inherent Limitations in Evaluating the Entity's Ability to Continue as a Going Concern
The potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for future events or conditions, considered in the aggregate, that raise substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. The auditor cannot predict such future conditions or events. **Accordingly, the absence of any reference to substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time in an auditor's report cannot be viewed as a guarantee of the entity's ability to continue as a going concern for a reasonable period of time."**
AICPA *2019*, *AU-C Section 570 – The Auditor's Consideration of an Entity's Ability to continue as a going Concern*

From interview on Business Day ….”it has been quite useful to see how this ecosystem has come together and how everyone is working together to get past this crisis. But included on that task force we have also included structures like the King Committee, the Audit Committee Forum……to answer some of your questions about how do the auditors respond to this crisis."
South Africa IRBA, Bernard Agulhas 11 May 2020

"In our view, the risk of being found liable for misleading or deceptive accounting estimates or forward-looking information is minimal, provided:

- any statements are properly framed as, for example, being based on the information available at this time
- any estimates, assumptions or statements have a reasonable and supportable basis and have been appropriately challenged, which involves good governance at board level for signing off on that information
- there is ongoing compliance with any continuous disclosure obligations when events or results overtake estimates, assumptions or statements.

Both directors and auditors should ensure that the circumstances in which judgements on accounting estimates and forward-looking information have been made, and the basis for those judgements, are properly documented at the time and disclosed as appropriate. This will minimise the risk that hindsight is applied when estimates, information and judgements are reviewed by others at a later time."
ASIC *(Australia) 29 April 2020*

Links to above: UK FRC podcast Mark Babington; UK FRC May Company Guidance; IAASB ISA 570 (Revised); AICPA (AU-C Section 570); UK FRC Guidance Update; ASBJ 9 April 2020; JICPA reference to ASBJ; ASIC 29 April 2020; South Africa IRBA Bernard Agulhas