Financial Reporting Pressures and the COVID-19 Crisis

Considerations for the Quarter Ending March 31, 2020

Part Two: Measuring and Reporting on Liquidity

As public registrants prepare their financial reports for the first quarter of 2020, they will be dealing with unique reporting judgments due to the economic impact of COVID-19 and recent government actions. Many of the financial reporting judgments will be especially difficult because of so many unique unknowns such as the duration of the crisis, whether vendors will be able to deliver on commitments, possible accounts receivable collection problems, and other matters that each registrant may be encountering.

To help our clients understand and assess the financial reporting matters under consideration, we are presenting a multi-part series dealing with several of these topics. Today's discussion is Part Two of the series and describes considerations related to measuring and reporting on a registrant's liquidity, which is a major component in the management discussion and analysis ("MD&A") section of a public filing.

Liquidity: A Critical Q1 2020 Disclosure for Investors

Measuring and reporting on a company's liquidity in ordinary times is often a cut-and-paste exercise, with a simple review to ensure a proper fit to the current economic environment. Due to the current crisis, many registrants will be required to start their analysis from zero and perform an assessment with a thorough and careful vetting of their situation and the current impacts on cash flow. Adding to the pressures this quarter, registrants may also need to form new judgments regarding access to financing such as the availability of current lines of credit, possibility for new credit, and access to other funding sources. Registrants will also need to carefully monitor federal, state, and local government assistance programs to assess the impact, if any, on the company's liquidity.

Financial Modeling and Forecasts

In Part One, Presenting Accounting Estimates, we described the need for a company-wide memo and financial model using various scenarios to measure the company's required accounting estimates. This same approach and documentation can also be the foundation for registrants to model and assess their liquidity needs and sources. Similar to measuring accounting estimates, the duration and severity of the current crisis, employing different scenarios, will be critical assumptions. Information obtained from economists, investment banks, and the government should all be considered in forming a registrant's assumptions, as well as industry and company specific factors.

Refresher on the Rules

Before starting any analysis, registrants are well advised to refresh themselves as to the specific requirements for liquidity disclosures, as well as for capital resources, which are often interrelated.

Important aspects from § 229.303 (Item 303 of Regulation S-K) Management's discussion and analysis of financial condition and results of operations, including for assessing liquidity, consist of:

- Discussions of the financial condition, changes in financial condition, and results of operations may be necessary such that readers can gain an understanding of the registrant's financial condition, changes in financial condition, and results of operations.
- Discussions of liquidity and capital resources may be combined when the two topics are interrelated.
- Discussions of relevant segment information and/or of other subdivisions of the business (e.g. geographic areas) when appropriate for financial statement users' understanding of the business.
- Identify any known liquidity trends or any known demands, commitments, events, or uncertainties that will result in or that are reasonably likely to result in the registrant's liquidity increasing or decreasing in any material way.
- If a material deficiency is identified, indicate the course of action that the registrant has taken or proposes to take to remedy the deficiency.

A complete reading of the rules is recommended. In sum, the objective of the liquidity and capital resources discussion is to provide a transparent and thorough picture of the company's ability to generate cash and to meet existing future cash requirements that are known or reasonably likely.

Distressed Business Considerations

If registrants are encountering significant financial strain as a result of the COVID-19 crisis, they may also need to assess whether the current conditions and liquidity strains, considered in the aggregate, raise substantial doubt about the entity's ability to continue as a going concern. The going concern standard requires management to assess future conditions, including both quantitative and qualitative factors, regarding the entity's ability within one year after the date the financial statements are issued (or within one year after the date the financial statements are available to be issued when applicable). This situation raises added disclosure requirements.

The standard for "substantial doubt" occurs when it is probable that the entity will be unable to meet its obligations as they become due within one year after the date the financial statements are issued (or available to be issued). This assessment should be made using the same "probable" definition applied to accounting contingencies.

This assessment also involves a very careful review of any plans to mitigate and offset the risks encountered by the registrant in fulfilling its financial obligations. A more detailed discussion regarding the reporting requirements when a registrant reaches this level of financial strain is beyond the scope of this discussion, and obviously, any registrant in this situation will be working closely with its advisors, legal counsel, and internal and external auditors.

We hope this discussion is informative and offers practical advice on an approach to deal with this unique circumstance arising from the current crisis. If you have questions or suggestions, please let us know. Thank you.