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INSIDE THIS PUBLICATION:

A roadmap for auditors: Tackling COVID-19 challenges

An e-Book publication sponsored by BLACKLINE

About us

COMPLIANCE WEEK

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BLACKLINE

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Inside this e-Book

PwC: Navigating audit committee responsibilities

Jaclyn Jaeger has more on recent PwC guidance for navigating audit committee duties amid the coronavirus pandemic.

Internal auditors will want to check out a recent publication from PwC on how to navigate core audit committee responsibilities amid the coronavirus pandemic.

Whether a pandemic-related disruption necessitates a reassessment of audit risk, audit committees "should ask management to take a fresh look at their internal audit annual plan and determine if it is still fit for purpose," the PwC publication stated. "They will also want to focus on ways to optimize internal audit's contributions in this new environment."

Audit committees should consider the following:

» Has internal audit reviewed the audit plan and determined which projects might need to be canceled, postponed, or accelerated in this new environment?
» Do changes impact external audit's plan to rely on internal audit's work?
» In what ways can internal audit provide assurance to management and/or the audit committee that the control environment is addressing any new risks identified?
» In what ways can internal audit support the company in ensuring that it is addressing new regulatory requirements related to economic assistance, like the CARES Act?

External auditor oversight

With external auditor oversight, audit committees "will want to understand from the external auditor what may have changed from prior quarters in the conduct of their interim review," PwC said. "Additionally, they will want to understand the external auditor's perspective regarding potential changes in audit risk, management's process for deriving significant estimates and impacts on internal control over financial reporting. Furthermore, the audit committee will want to understand the audit work that may have been performed over significant transactions or accounting judgments during the reporting period."

Some audit committee considerations, as suggested by PwC, include:

» How has working remotely impacted the way the external auditor executed its interim review, including obtaining evidence of the company's internal controls procedures?
» Are the form and frequency of communication and engagement working satisfactorily for both management and the external auditor, and does the auditor have sufficient access to personnel and documents to complete their work?
» What are the significant audit risks and how have they changed given the current conditions?
» How has the external auditor's perspective on materiality changed due to management's revised projections and what impact has that had on the audit scoping?
» As it relates to certain audit work generally performed on location (e.g., physical inventory observations), what alternatives are being planned?

PwC's guidance also includes a talk on the audit committee's role in ethics and compliance oversight. Such considerations include, for example, whether to change the frequency and reporting criteria of whistleblower reporting to the board; whether a plan needs to be in place to perform virtual investigations; and to what extent the company is prepared for a potential increase in whistleblower or ethics and compliance matters as employees transition back to a normal work environment. ■

Coronavirus disrupts firms' financial reporting

Aaron Nicodemus reports on how the pandemic is hurting firms' bottom lines and what steps they are taking to reduce spending.

Publicly traded companies took advantage of a 45-day extension beginning in March for filing certain financial reports to the Securities and Exchange Commission (SEC).

As of March 23, 42 public companies had opted to take advantage of the SEC's regulatory relief, according to Audit Analytics, an independent research and data provider that focuses on public companies. The industries represented range from hospitality, hotel, and casino companies to businesses dealing in energy, manufacturing, and insurance.

As part of the relief, firms had to report why they couldn't file required financial disclosures; ways in which coronavirus-related disruptions hurt their bottom lines, and steps they were taking to reduce spending as disruptions rippled through their suply chains.

The SEC granted the extension March 4 to provide publicly traded firms 45 extra days to file certain disclosure reports that had been due between March 1 and April 30. The SEC issued the order in response to fallout from the coronavirus, which it says may affect the companies' abilities to provide accurate and timely information about how the pandemic is affecting their operations.

In a March 20 blog post, Audit Analytics said the first company to take advantage of the SEC's reporting extension was an energy company whose facility in Wuhan, China—located at the heart of the worldwide coronavirus outbreak—was shuttered for a considerable period. Other companies citing coronavirus disruptions to their businesses were an insurance carrier serving the restaurant industry and a gaming company that provides equipment to casinos.

In other disclosures not related to the extension, "hundreds of companies" have disclosed closures or reduced operations. "The most significantly impacted industries have been retailers, restaurants, and casinos—though the impacts have been far reaching," the blog post said.

Many companies are also reporting measures that will reduce spending, like "cancelling share buybacks, drawing on credit facilities, reducing dividends, reducing capital expenditures, and some are even reducing executive pay," the blog post said.

At what point should companies be making coronavirus-related disclosures?

"Disclosures need to be tailored around individual company circumstances," said Timothy Brown, audit partner at KPMG. "Things are moving really fast. What we see on Monday might be different on Friday. It's difficult for companies to know because of all the uncertainty that lies ahead."

And yet, the rules for what disclosures are required haven't changed, he said. All that has changed is a delay in when those disclosures must be filed.

Peter Cohan, author and professor of strategy and entrepreneurship at Babson College in Wellesley, Mass., said the loosening of financial reporting requirements could hurt investors, because the coronavirus is affecting different companies in different ways.

"Some companies are enjoying a surge in demand for their products and services, and others are suddenly close to running out of cash unless they can get a government bailout," he said. "Loosening disclosure requirements creates an information vacuum for investors at the very moment when more information is essential to making the right investment decision."

Cohan said companies should be transparent about their contingency plans, so investors can properly measure the amount of risk they would take by investing.

Several companies have asked the SEC for extensions because their CEO has tested positive for the coronavirus or has gone into quarantine because of possible exposure, Audit Analytics said. Other companies have reported that key employees are either infected or living in quarantine.

Cohan said companies should report coronavirus infections in a timely manner, saying, "Without such disclosure, companies are holding on to market-moving information that they should disclose to investors so they can make informed decisions."

Coronavirus' effect unprecedented

Audit Analytics also found the impact of the coronavirus on publicly traded companies is already unprecedented, a mere four months since the first case was reported in China.

The company's research found 768 instances of the word "coronavirus" or "COVID-19" in SEC filings in 2020, through March 4. By comparison, the H1N1/Swine Flu pandemic of 2009-10 only generated about 350 disclosures by public companies over its entire course of infection.

Part of the reason so many companies have already mentioned coronavirus in disclosures has to do with timing, as the coronavirus-related disruptions hit just as the majority of large companies were compiling information for their annual reports, Audit Analytics said in a March 6 blog post.

But with the coronavirus pandemic spreading quickly through Europe and North America, the hits to public companies' bottom lines from coronavirus-related disruptions has only just begun. ■

CAQ exec: How audit must adapt during coronavirus

CAQ Executive Director Julie Bell Lindsay shares insights with **Maria Murphy** on how auditors are coping with coronavirus challenges.

In an interview with Compliance Week, Julie Bell Lindsay, executive director of the Center for Audit Quality, shared her perspectives on how public company auditors are coping with new challenges from the coronavirus pandemic.

"It's unquestionable that the current environment has presented the profession with challenges and uncertainties they would not have thought of six months ago," Lindsay said. "Surely it is making their job more difficult, but auditors have quickly adapted without ever losing their focus on audit quality."

"The [Securities and Exchange Commission's] Chairman [Jay] Clayton recognized early on that continued well-functioning capital markets are an essential component of the U.S. response to and recovery from the current pandemic, and public company auditors are a key gatekeeper in the markets," Lindsay said. "The SEC has been very active in sharing guidance and expectations, and I have been incredibly impressed with the way the profession has focused on continually ensuring the appropriate actions are taken for the stability and protection of the capital markets."

Although many calendar year-end 2019 audits were completed before the coronavirus pandemic hit, first-quarter earnings releases and quarterly reports have included COVID-19 impacts on businesses and their employees for the first time. Also, March 31 and June 30 year-end audits are still in progress.

Three fraud risks

COVID-19 presents some significant fraud risks. The three sides of the fraud triangle—pressure, opportunity, and rationalization—will be heightened during this economic downturn and health crisis.

Lindsay

Organizations are under new pressures to meet business goals and earnings expectations. Layoffs and downsizings are putting employees under significant financial pressures and may create psychological rationalizations to commit fraud, either to help themselves or the company. Working remotely can create new opportunities to commit fraud as internal controls and processes are not functioning normally, and it may be the first time that client personnel and their audit committees are working remotely.

It's unquestionable that the current environment has presented the profession with challenges and uncertainties they would not have thought of six months ago. Surely it is making their job more difficult, but auditors have quickly adapted without ever losing their focus on audit quality.

Lindsay shared steps public companies and auditors should take to reduce fraud risks. "Companies are scrambling right now, and auditors should not lose sight of this," she said. "Tone at the top must be reinforced through management and boards and audit committees that no matter what happens there will not be a sacrifice of ethics or controls or culture, so that employees can take their lead." Lindsay has seen this done effectively at audit firms, where leaders are communicating audit quality is not to be sacrificed despite the current situation.

She also encourages auditors and their clients to review and revise their risk assessments and consider how the coronavirus will affect all financial statement areas, including the company's disclosures. Auditors must continue to adapt to challenges of travel restrictions, working remotely, and completing audits virtually without sacrificing audit quality. "Audit plans cannot be static," Lindsay said. "Auditors are by their nature creative and skeptical, and in this environment they need to continue to be creative but never lose sight of the skepticism."

Lindsay has been impressed with how audit firms have become an essential repository of coronavirus information and the extent of communications from auditors to their clients' management, audit committees, and regulators. "Audit firms have been engaged in activities 24/7 to provide resources to their engagement teams and clients on how to adapt to COVID-19," Lindsay said. "Even in normal times, auditors are the nexus of communications, but the continuous information flow among stakeholders in the financial reporting supply chain has been impressive and beneficial for all."

Lindsay also commended audit firms for putting their employees first without sacrificing audit quality, including flexible work arrangements, avoiding layoffs, and partners taking pay cuts. Firms have also contributed significant amounts of money and time to help individuals and businesses during the pandemic, including donating millions of dollars to healthcare professionals, creating information and resources, and volunteering in their communities.

More CAQ guidance

The CAQ published a COVID-19 Resource (https://www.thecaq.org/caq-covid-19-resource/) in April for auditors and audit committees as they complete quarterly reviews and plan for 2020 audits. It includes key audit, accounting, and disclosure implications of COVID-19, along with fraud risks. It also includes other resources from the SEC, Public Company Accounting Oversight Board, and Big Four firms on important considerations for accounting and financial reporting resulting from the pandemic.

In addition, the CAQ's resource page includes a growing number of resources developed by audit firms, standard setters, and regulators to help auditors, management, and audit committees understand the impact of the COVID-19 pandemic on financial reporting and oversight. Click here to access that page. ■

Companies are scrambling right now, and auditors should not lose sight of this. Tone at the top must be reinforced through management and boards and audit committees that no matter what happens there will not be a sacrifice of ethics or controls or culture, so that employees can take their lead.

AICPA best practices for conducting remote audits

Auditors facing risks and reporting issues as a result of coronavirus have new guidance from the AICPA. **Maria Murphy** reports.

As the coronavirus pandemic continues to spread and employees work remotely, auditors face the challenges of completing audits in process or meeting client deadlines for audited financial statements.

As such, the American Institute of Certified Public Accountants (AICPA) is sharing best practices to ensure auditors of private companies follow its Accounting Standard Board standards while working remotely. The agency hosted a Webcast on March 23 on private company auditing standards on remote auditing, with AICPA Chief Auditor Bob Dohrer and Andrew Prather, audit shareholder at Clark Nuber.

An important consideration is that the auditing standards generally address "what" evidence is required and rarely dictate "how" the evidence is obtained. Dohrer encourages auditors to be creative and innovative while complying with the standards.

Scope limitations can, however, affect the auditor's ability to complete procedures and the type of audit report to be issued. Auditors may have difficulties accessing client records, testing internal controls, observing inventories, confirming accounts, obtaining updated cash flow forecasts needed for impairment and going concern analyses, performing subsequent event procedures, and obtaining representations from management and legal counsel.

During this crisis, there are new risks that require assessment and extra audit attention, including fraud, losses of customers, changes in supply chains, and changes to internal controls. The AICPA notes that auditors must maintain professional skepticism and make sure that the quality of audit evidence is still sufficient to reduce overall audit risks to the appropriate level. They may not be able to use analytics the same way as in prior audits, because historical comparisons have become difficult or impossible.

A major issue, notes the agency, is that existing internal controls over financial reporting may not be functioning. It is likely clients are processing transactions and preparing financial information differently because the people responsible for them are not in the office or the controls cannot work the same way in the current environment. There may be new risks that require changes in controls not yet put in place or not yet operating effectively. Auditors may not be able to rely on the effectiveness of internal controls as they usually do and may have to increase substantive testing. Even if not relying on internal controls, auditors must obtain evidence beyond inquiry that controls continue to be in place to prevent and detect material misstatements in the financial statements.

Accounting issues that need to be top of auditors' minds include impairment of tangible and intangible assets, valuation of investments, financial instruments and credit losses, debt obligations, lease assets and liabilities, contingent liabilities, and revenue recognition. Management must evaluate the firm's ability to continue as a going concern under GAAP requirements, the AICPA contends, and subsequent events relating to COVID-19 may require adjustments to the financial statements and/or additional disclosures.

It may be impossible for auditors to comply with the auditing standards to issue audit reports in certain client situations. Auditors should consider working with their clients on getting extensions to financial statement deadlines along with helping them obtain waivers or other contract modifications from financial institutions, lenders, and suppliers.

Dohrer advises that very few businesses will escape the repercussions of the pandemic. When working remotely, auditors need to have a different mindset and change their audit procedures in response to changes in their clients' businesses and the economy overall. ■

Transforming the Audit with Technology

Reducing Time, Cost & Risk with Accounting Automation

BLACKLINE

When it comes to the audit, it's rare to hear clients and audit teams finish up the exercise and declare, "Well, that was easy!"

Experience has shown that the year-end audit can be a painful ordeal. It can mean weeks or months of digging up information from applications, shared drives, spreadsheets, and paper binders across multiple locations and time zones.

It can involve endless back-and-forth between accountants and auditors over email, in on-site meetings, and on conference calls. Accountants chip away at the audit team's Prepared by Client (PBC) list, but discrepancies can trigger more sampling and testing—and anxiety over a potential material error.

And for accounting teams, the audit burden often comes on the heels of already tight monthly close deadlines. Accounting professionals have invested a lot of time and effort into generating clean financials, and don't necessarily relish the idea of their work being scrutinized.

Unpleasant though it may be, the year-end audit is a necessary fact of life. So are audit activities that go on throughout the year, with periodic walkthroughs, quarterly 10-Q reviews, and SOX 404 controls testing. All the while, both clients and auditors are under pressure to stay current on ever-changing regulatory requirements and audit standards.

What isn't necessary is the stress and inefficiency that surrounds audits.

Minimizing Audit Pains & Apprehension

Minimizing audit pain points requires rethinking manual accounting processes and embracing modern financial close technology. But first, it's important to identify some of the common challenges faced during the audit:

- Regular meetings to discuss PBC requests and their status
- Unexpected fees due to inefficiencies or delays in providing requested documents or evidence
- Difficulty chasing down supporting documentation
- Lack of transparency into, and accountability for, audit requests and findings

Your organization can improve the audit process while building a foundation for continuous process improvement through four key focus areas.

Finance Automation

Using technology to automate month-end close processes, from account reconciliations to balance sheet fluctuation analysis and beyond, eliminates error-prone manual work. Ultimately, this contributes to clean, validated financial records.

Stronger Controls

Customers can utilize controls embedded within financial close software to help ensure adherence to policies, procedures, and regulations, and build out a systematic financial controls environment.

Centralized Information

A single repository for accounting close information simplifies how accounting teams and auditors find, share, and review information. Drilling down into transactional details takes minutes—compared to hours or days with a manual approach.

Direct Access for Auditors

Providing external and internal auditors with read-only access to a financial close platform dramatically reduces manual work for both client and auditor. There's less prep time, back-and-forth, and chasing down details.

When core close activities are streamlined, the client's accounting and finance team can focus on delivering necessary and thoroughly validated information to both stakeholders and auditors. And auditors are better able to perform their work with access to supporting documents and a built-in trail of activities and approvals.

3 Key Advantages of Financial Close Technology in Audit Processes

With financial close technology, clients and auditors move from detective, reactive audits to a proactive, automated approach that delivers three key advantages:

1. Introduces new transparency and trust in the client-auditor relationship
2. Saves time in the audit process
3. Saves money

1. The Client-Auditor Relationship

Neither company management nor the auditor wants a contentious relationship, yet the client-auditor relationship is somewhat uncomfortable by design. The auditor, after all, must be independent, and is tasked with verifying, validating, and forming their own opinions—regardless of how trustworthy and cooperative the client may be.

But despite a naturally adversarial component, the client-auditor relationship doesn't have to be strained. In fact, both sides would prefer to collaborate and support one another. This starts with a foundation of mutual respect and transparency, and is supported by modern financial close technology.

Transparency doesn't exist when vital information is hidden away in spreadsheets or binders that are difficult to access. This approach leads to a lot of manual work for both client and auditor when it comes time to extract and review that data.

Sometimes it's a devilish detail: a paper document is missing a date, or a signature is illegible. A small oversight like that can cascade into a major problem. Electronic timestamps and sign-offs on information aggregated in a finance automation solution eliminates that risk.

Transparency builds trust. Auditors love it when they can easily assess the who, what, when, where, why, and how behind any account balance or journal entry. The hassle of back-and-forth exchanges and piecing together details is replaced by confidence that information is documented and accessible in a single location.

Transparency and trust extend across all levels of both accounting and audit teams, from staff to senior executives. It's a win-win relationship that pays dividends for years to come because the auditor can serve more as a strategic advisor, better able to help the organization understand and comply with complex accounting regulations.

Audits are a non-event for us now. Auditors can pull the information they need directly out of BlackLine. It's a huge time savings for us, and they really appreciate not waiting on us.

JEANETTE NIMMO
GL GLOBAL PROCESS OWNER, HYATT HOTELS

2. The Audit Process

Even at organizations that rely on manual accounting processes, many client-auditor relationships are solid. Still, both parties agree that there's plenty of room for process improvement.

Between ongoing SOX procedures, quarterly reviews, year-end audits, and other process audits, it's no wonder companies often feel like the auditors never leave. And while there are plenty of important reasons to have another set of eyes on things, everyone agrees that audits usually take more effort than they'd prefer.

Modern technology for financial close automation enables more efficient audits in several ways.

Easy PBC Management

Even the client-audit teams with the healthiest relationships have experienced challenges around the process of requesting and providing information to support audit procedures. Before the audit can even get started, the Prepared by Client (PBC) process is often the cause of a decent amount of "he said, she said."

This adds stress and inefficiency beyond that which is already caused by the actual review and testing. Without a centralized process, and without a centralized record of which items were requested, by whom, and when, it's too easy for requests and responses to get lost in the shuffle.

If an auditor had a request to see reconciliations, they were going to one group to get it, then to another group to see the journal entry behind it. With BlackLine, we have one consolidated place for everything, and the process is streamlined.

SHAKORA DERIXSON
FINANCE MANAGER, SUNTRUST BANKS

With everything stored and accessible in a single cloud solution, both staff and auditors have a unified place to request and provide PBC items, as well as monitor status. Rather than recurring meetings to hash through a list, both parties can readily see what's done and what's in progress.

And better yet, documents themselves can be attached to their corresponding request. No more finger pointing.

Less Prep Time

Staff no longer need to spend days manually pulling, preparing, and aggregating spreadsheets and paper files when financial close technology is in place. Instead, auditors are given read-only access to a platform where the most critical activities are performed.

Whether it's testing individual journal entries, ensuring proper approval, or sampling balance sheet accounts for substantiation, integrating the audit trail and the related support saves time. Companies can attach back-up documentation and use rules to limit or automate approvals.

For a client, providing hard copy files either requires copying—and therefore wasted paper and time—or parting with the only version of something and risking that it could disappear. The same is true for sharing files on flash drives or other hardware. Though less time is wasted, the risk is increased.

With everything in the cloud, there's a single source of the truth and auditors can sample and review the records they need, anywhere and anytime.

Limited Risk & Less Confusion

It's not uncommon for management to identify adjustments or require modifications to results or documentation. After all, that's what reviews are for.

But what if the auditors were already provided a copy? Not only can version control issues cause confusion and subject the client to added questions or scrutiny, it wastes time for both sides if items must be requested and tested again.

I knew we hit a home run when I had two external auditors in my office asking for access to BlackLine. It really helped to resonate in terms of what we've done and how we've helped to make their process efficient.

JOHN ZIMMERMAN
DIRECTOR, FINANCIAL DATA SYSTEMS, THE HERSHEY COMPANY

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3. The Cost

While there may not be a specified audit fee discount for embracing technology, there are a number of ways technology helps minimize costs.

Reduced Travel Expenses

With anywhere, anytime access to centralized information in BlackLine, auditors can work remotely. Onsite time is limited to certain times or procedures, and the need to visit subsidiary or satellite locations is minimal.

This means that travel and other costs associated with on-site work are much lower. For auditors, this allows resources to flex their time between clients, potentially increasing productivity and billable time.

Less Sampling & Testing

Manual processes are error prone. If auditors find errors, they may proceed with additional sampling that can trigger unexpected fees, as extra testing is outside the anticipated scope.

Technology limits the risk of error and provides best practices and segregation of duties "out of the box." As a result, auditors may focus on testing IT controls or reviewing configurable business rules rather than performing extensive sampling and detailed testing of transactions.

It took us two to three hours to get all the reconciliations into the conference room, put them in order, and make sure they were complete. Now we just have to set up the auditor log in, which takes minutes.

PAIGE WILLIAMSON
ASSISTANT CONTROLLER, SADDLE CREEK

How BlackLine Simplifies & Streamlines Audits

Top accounting and finance teams are streamlining audit processes, reducing costs, mitigating risk, and building collaborative client-auditor relationships with the BlackLine finance automation platform.

BlackLine brings efficiency, visibility, and controls to Accounting and Finance. The unified and integrated platform drives continuous improvement across the organization and embeds quality into financial processes and records.

That quality bubbles up to support yearly and ongoing audit activities. It contributes to an efficient and positive process that allows an audit team to obtain sufficient and appropriate audit evidence that confirms key audit assertions, particularly in the areas of completeness and accuracy.

BlackLine customers consistently credit the platform for helping them accelerate and simplify audit processes. For Hyatt Hotels Corporation, a leading global hospitality company, audits are a non-event because the auditors can pull the information they need directly from BlackLine.

Saddle Creek Logistics Services, with nearly three dozen locations in the U.S., has cut audit prep time from three hours to minutes by giving auditors read-only BlackLine access.

And SunTrust Banks has eliminated multi-step processes for auditors to review reconciliations and corresponding journal entries.

Audits may be a fact of life, but stress and anxiety don't need to be a part of the process. Companies that utilize financial close technology move through audits faster and with better results, and they have stronger, more transparent financial management throughout the year.

BlackLine has enabled us to improve the efficiency and results of the end-to-end audit process. It's really given us and our audit committee comfort that we have embedded controls within our business.

ACCOUNTING MANAGER, UTILITIES COMPANY

Transforming the Audit with Technology

BLACKLINE

Going concern opinions at lowest level in 19 yrs

A recent Audit Analytics report reveals some surprising trends for going concerns based on 2018 numbers. **Maria Murphy** has more.

Public company audit opinions communicating doubts about their ability to continue as going concerns reached a 19-year low in 2018, based on the latest report from Audit Analytics, which tracks going concern opinions from the year 2000.

The study indicates an estimated total of 1,774 reports disclosing this uncertainty for 2018 based on an analysis of Securities and Exchange Commission filings through November 2018—the lowest amount over the 19 years analyzed.

On a percentage basis, 14.5 percent of audit opinions filed in 2018 will include an uncertainty related to going concern. This is the 10th consecutive annual drop since the peak of 21.1 percent in 2008 during the financial crisis.

There was a decrease of 99 going concern reports from 2017 to 2018. According to the report, this is not an indication that fewer companies are experiencing risks, but rather the change is attributed to "attrition from the population of going concerns." There were 585 companies that filed a going concern opinion in 2017 but did not in 2018. Of those, 167 filed a clean opinion, but 418 did not file any audit opinion either because they were no longer SEC filers or were potentially out of business.

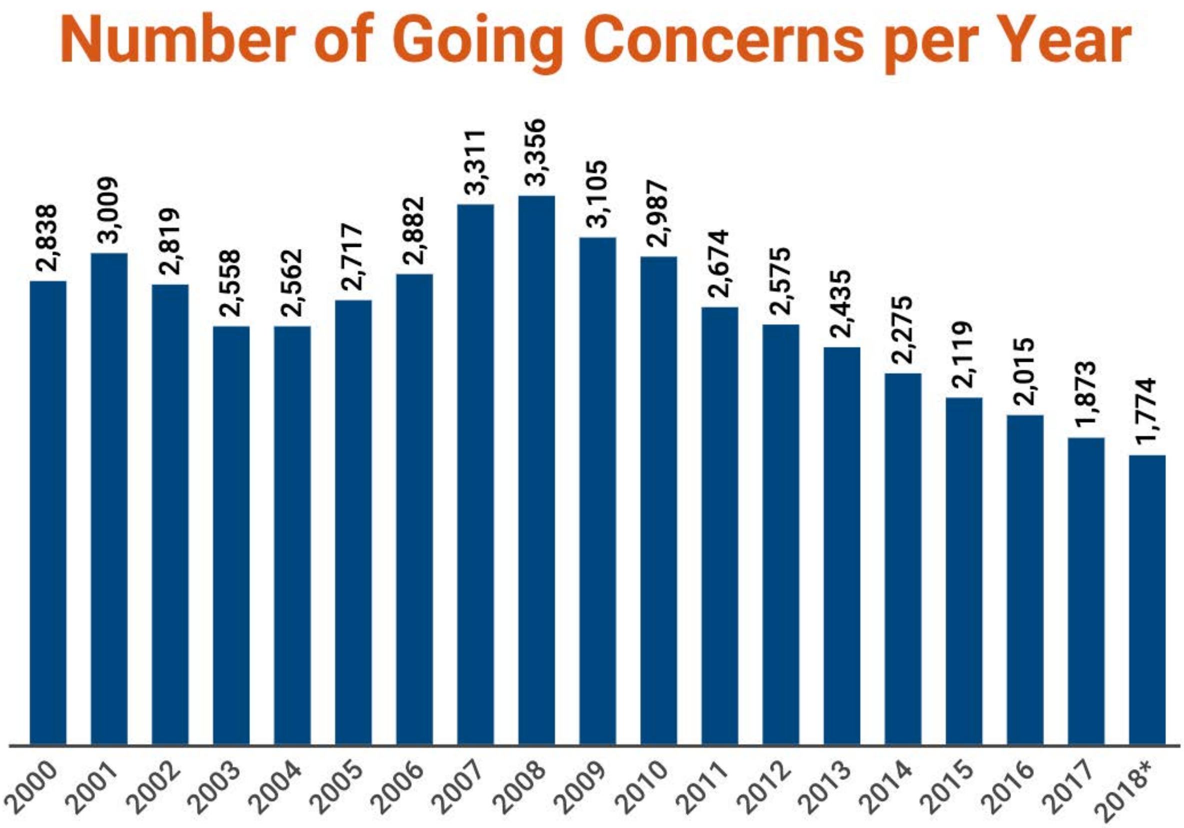
The analysis also reported 440 expected new going concerns (opinions filed this year with a clean opinion filed in the prior year) in 2018, the lowest amount in 18 years of reported data. Of this amount, 21.5 percent were included in recent initial public offerings, which the report indicates should not necessarily be viewed as a negative economic event.

Going concern reporting requirements in both accounting and auditing standards call for management and auditors to share responsibility for analysis and reporting of substantial doubt regarding going concerns. These standards will get additional scrutiny for 2019 fiscal year reporting as a result of the uncertainties resulting from far-reaching impacts of the coronavirus pandemic.

The American Institute of Certified Public Accountants has already put going concerns on the list of auditor reporting issues as a result of COVID-19. Daily changes in the United States and global economies and severe impacts to so many industries are likely to make future going concern assessments very difficult.

Don Whalen, director of research at Audit Analytics, anticipates there will be a spike in the number of new going concern opinions in the next report, with certain sectors more likely affected, following eight years of a relatively stable environment since the financial crisis in 2007-2008.

In addition, according to Whalen, going concern population attrition data may provide some interesting results in the 2019 analysis. ■



*2018 is estimated.

Source: Audit Analytics

Audit committees prep for coronavirus challenges

Maria Murphy talks with Hille Sheppard of Sidley Austin on tactics for audit committees confronting coronavirus pandemic uncertainties.

In an interview with Compliance Week, Hille Sheppard, partner and co-leader Global Securities and Shareholder Litigation Practice at Sidley Austin, shared her insights on issues public company audit committees need to prepare for during the coronavirus pandemic.

For many public companies, the month of March was a challenging time, with many new operational uncertainties and the first impacts to financial results from the coronavirus. As companies now report first-quarter earnings and prepare quarterly reports, their audit committees must be focused on new operational challenges and compliance risks.

“Audit committees must ask a lot of probing questions of management,” Sheppard said. “How confident are they about internal controls? Can they close the books? How rigorous is the process? Are they getting information from their lines of business?” Any material changes in internal controls over financial reporting are required to be reported in the current quarterly report.

Changes to the economy that have already occurred and are projected to continue are raising accounting questions, especially in the area of asset impairments. Audit committees should bring their perspective about the business to their discussions with management and consult with their auditors about accounting implications of the pandemic. “It is important that they get the information they need and document judgments made and conclusions reached, because there will probably be second guessing,” Sheppard said.

Sheppard recommends that management and audit committees engage their auditors early, more so now than normally. “Although first-quarter results are unaudited, auditors want to be part of the

"Audit committees must ask a lot of probing questions of management: "How confident are they about internal controls? Can they close the books? How rigorous is the process? Are they getting information from their lines of business?"

Hille Sheppard, Partner & Co-leader, Global Securities and Shareholder Litigation Practice, Sidley Austin

discussions and not be surprised," she said.

Companies and their audit committees must do the best they can to deal with all of the uncertainties and accurately report their current situation. "Judgments about the future are going to be particularly challenging now," Sheppard suggests. "They need to do their best to thoughtfully and accurately report their current situation but call it as they see it. The reality is that things could potentially be worse in the second quarter than they anticipated, and they will have to explain what happened and add their perspective to explain why things changed." Sheppard reminds audit committees that their public reporting should be consistent with what the board has been told.

She also recommends they take a close look at their risk factor disclosures, which serve as a warning to investors but can also be protective, to make sure they accurately describe the current risks. Members of audit committees who serve on multiple boards should bring their perspective from those experiences to that review.

Although the Securities and Exchange Commission has provided certain reporting relief, some companies may not be taking advantage of it. SEC reporting requirements should still be top of mind for audit committees, and known and potential impacts of COVID-19 and forward-looking statements should be disclosed in first-quarter reports. "The SEC is still scrutinizing management's discussion and analysis, including disclosures on uncertainties about liquidity and changes to financing and capital resources," Sheppard said. "They are also looking at companies who leave in place earnings guidance from year-end that no longer is supported, even if they had good support at year-end when they did their annual reports, and whether it is really realistic for them to achieve that guidance now."

Audit committees should be engaged in planning for contingencies and crisis management. Sheppard recommended boards and audit committees should ask questions of management and document the discussions about issues like conserving liquidity and need for new financing, expense reductions, potential talent disruption from reductions in workforce and compensation, management succession planning, and disruptions to supply chain and production processes. "These issues are extremely important. While audit committees do not want to distract management from the difficult job of running companies at this time, they have an obligation to keep themselves informed and can bring the appropriate perspective by asking questions and can provide guidance," Sheppard said.

Board members and audit committees can help management set the right tone at the top. "Audit committees should remind management to prioritize the health and safety of employees, customers, vendors, and other constituents because it's the right thing to do and mitigates risks for the company," Sheppard recommended.

Sidley Austin provides additional advice for boards and audit committees on the company Website, and it has information on regulatory, transactional, and litigation issues companies are facing in its COVID-19 Resource Center. ■

Luckin Coffee, iQIYI fraud points to wider China issue

Jaclyn Jaeger explores scathing reports against China-based Luckin Coffee and iQIYI that point to larger U.S. accounting problem.

Luckin Coffee—the China-based equivalent of Starbucks in the United States—is not worth a hill of coffee beans right now, following allegations it is a "fundamentally broken business" that fabricated most of its 2019 sales. But it's not the only China-based company alleged to be running a scam.

"When Luckin Coffee went public in May 2019, it was a fundamentally broken business that was attempting to instill the culture of drinking coffee into Chinese consumers through cut-throat discounts and free giveaway coffee," begins an 89-page anonymous report shared by short-seller firm Muddy Waters. Right after its $645 million IPO, the company had "evolved into a fraud by fabricating financial and operating numbers" starting in the third quarter of 2019.

"Luckin Coffee delivered a set of results that showcased a dramatic business inflection point and sent its stock price up over 160 percent in a little over two months," the anonymous executive summary continued. "Luckin knows exactly what investors are looking for, how to position itself as a growth stock with a fantastic story, and what key metrics to manipulate to maximize investor confidence."

Specifically, the report alleged that:

» The number of items per store per day was inflated in the third and fourth quarters of 2019;
» Items per order had declined from the second quarter to the fourth quarter 2019, and the effective selling price was inflated in the third quarter of 2019;
» Luckin Coffee overstated advertising expenses and may recycle overstated advertising expenses to inflate revenue in the third quarter of 2019; and that
» Net revenues from other products were inflated in the third quarter of 2019.

In a response statement issued in February, Luckin Coffee, at first, "categorically denie[d]" all allegations in the report, calling them "misleading and false." The company claimed the report's methodology was "flawed, the evidence is unsubstantiated, and the allegations are unsupported speculations and malicious interpretations of events."

Special committee formed

In its latest statement on the matter, the company announced its board of directors has formed a special committee to oversee an internal investigation into these matters. The special committee is comprised of three independent directors: Sean Shao, Tianruo Pu, and Wai Yuen Chong, with Shao serving as chairman. Additionally, the special committee retained Kirkland & Ellis as its independent outside counsel and FTI Consulting, an independent forensic accounting expert.

According to Luckin Coffee, the special committee on April 2 brought to the attention of the board information indicating that, beginning in the second quarter of 2019, Chief Operating Officer Jian Liu and several employees reporting to him "engaged in certain misconduct, including fabricating certain transactions." In response, the special committee recommended suspending employees implicated in the misconduct, as well as suspending and terminating contracts and dealings with the parties involved in the identified fabricated transactions.

"The board accepted the special committee's recommendations and implemented them with respect to the currently identified individuals and parties involved in the fabricated transactions," Luckin Coffee stated. "The company will take all appropriate actions, including legal actions, against the individuals responsible for the misconduct."

Inflated costs and expenses

The information identified at this preliminary stage of the internal investigation indicates the aggregate sales amount associated with the fabricated transactions from the second quarter of 2019 to the fourth quarter of 2019 amount to around RMB2.2 billion (U.S. $310 million). Certain costs and expenses were also substantially inflated by fabricated transactions during this period, the company stated.

As a result, investors should no longer rely upon the company's previous financial statements and earning releases for the nine months ended Sept. 30, 2019, and the two quarters starting April 1, 2019, and ended Sept. 30, 2019, including the prior guidance on net revenues from products for the fourth quarter of 2019, and other communications relating to these consolidated financial statements. The investigation is ongoing, and the company said it will continue to assess its previously published financials and other potential adjustments.

As of press time, the company had fired Co-Founder and CEO Jenny Zhiya Qian and Chief Operating Officer Jian Liu after more evidence has come to light regarding the fabricated transactions. Liu had previously been suspended. Six other employees "who were involved in or had the knowledge of the fabricated transactions" have been suspended or placed on leave, the company said.

Wider China problem

The apparent scam that is Luckin Coffee, however, is just one example of a much broader, disturbing problem in the United States, in which China-based firms listed on U.S. stock exchanges con U.S. investors out of billions of dollars. In fact, the problem is so widespread that it was the focus of a 2017 documentary, called "The China Hustle."

Such scams continue to generate significant issues for the U.S. accounting and auditing community, as well, since U.S. auditors don't have jurisdiction over those listed on the NASDAQ that are based in China. In November 2019, the Securities and Exchange Commission and the Public Company Accounting Oversight Board met with the Big Four "to discuss audit quality across their global networks and certain of the challenges faced in auditing public companies with operations in emerging markets, including China."

Among the issues discussed was that the PCAOB "continues to be prevented from inspecting the audit work and practices of PCAOB-registered audit firms in China on a comparable basis to other non-U.S. jurisdictions." During the November 2019 meeting, the SEC said it made clear that with the PCAOB restricted in its inspection efforts in China, it "expect[s] U.S. audit firms to bring appropriate increased attention and resources to their internal and cross-network quality control processes."

Floodgates opening?

On April 7, a second report emerged against another Chinese company by another investor activist firm, this one published by Wolfpack Research (with assistance from Muddy Waters) regarding China-based video-streaming company iQIYI. That report alleges iQIYI overstated its revenues and subscriber numbers.

According to the report, iQIYI "was committing fraud well before its IPO in 2018 and has continued to do so ever since. Like so many other China-based companies who IPO with inflated numbers, IQ is unable to legitimately grow their business enough to true up their financial statements."

Wolfpack Research estimates that iQIYI inflated its 2019 revenue by approximately RMB8 billion (U.S. $1.13 billion) to RMB13 billion (U.S. $1.84 billion), or up to 44 percent. It does this by overstating its user numbers by approximately 42 percent to 60 percent and then inflates its expenses, "the prices it pays for content, other assets, and acquisitions in order to burn off fake cash to hide the fraud from its auditor and investors," the report states.

Like Luckin Coffee, iQIYI is denying the allegations. "The company believes that the report contains numerous errors, unsubstantiated statements, and misleading conclusions and interpretations regarding information relating to the company," iQIYI stated. ■

Analysis: Luckin Coffee saga a case of déjà vu?

Financial crime expert **Martin Woods** ponders how foreign firms, like Luckin Coffee, can apply proper U.S. standards of compliance.

In April, Chinese regulators raided the offices of Nasdaq-listed Luckin Coffee after the company announced its former chief operating officer had overstated roughly $310 million of sales.

Incorporated in 2017, the company was listed on Nasdaq in early 2019 and operates in excess of 4,500 coffee shops in China. Seen as a local rival to Starbucks, Luckin Coffee achieved a market value of $4 billion, but share prices have fallen by 80-percent-plus since word of the fabricated transactions.

So, what went wrong and how? When I read about Luckin Coffee, I immediately thought of the documentary "The China Hustle," which chronicles the story of multiple Chinese companies undergoing a reverse takeover, whereby the companies acquire an existing, but substantially dormant, Nasdaq trading company. The primary character of the film, Dan David, produced compelling evidence of orchestrated frauds that saw companies and their shares massively overvalued before being dumped upon investors who lost billions of dollars, perhaps as much as $50 billion.

Like a number of other people, I pondered if this was a case of déjà vu or déjà poo (same old crap)? Within the film, one of the journalists smiles wryly when he says, "There's an old joke that the biggest lie on Wall Street is that this time it's different." So, is Luckin Coffee different? How were the sales so overstated, and who failed to identify or report this?

"The China Hustle" tells the story of Chinese criminals supported by U.S. professionals, wittingly or unwittingly, defrauding U.S. investors. There have been no reports of the Securities and Exchange Commission or authorities in China taking action against these criminals (meanwhile, the SEC has reportedly begun probing Luckin Coffee's misdeeds). On the contrary, the investigator and whistleblower who exposed some of the frauds, Kun Huang, was sent to jail. So while the SEC now has a reward program for whistleblowers, the Chinese authorities lock them up.

In 1993, as a London-based detective, I worked on joint investigations with the New York District Attorney's Office examining reverse merger stock frauds on Nasdaq. The frauds were perpetrated by organized crime groups in the United States, often supported by London-based lawyers and accountants. Under the old "Reg S rules," fraudsters persuaded non-U.S. investors to buy shares at a discount to the market price, thereby incurring an instant profit (albeit they were locked into the shares for 12 months). Behold, after 12 months, when they were able to sell the shares, the price had dropped; they had been caught within a pump-and-dump scheme.

There was very little difference between my investigations and those referenced in "The China Hustle," such that this time it wasn't that different at all.

That said, Luckin Coffee is different because the company self-reported the false sales figures, and the Chinese regulator appears to be taking action. Nonetheless, U.S. investors have undoubtedly lost a lot of money, which may never be recovered. The real issue here is just how does the SEC ensure foreign companies publicly traded in the United States but operating and controlled overseas apply the standards of compliance, financial reporting, and even whistleblower protections demanded of such companies in the United States? Moreover, how do you protect investors who may invest in such companies through your firm?

It's not a case of "do you like your coffee with milk?"—it is more a case of liking your coffee with true and accurate financial reporting. Anything else can leave a bitter taste in your mouth and a big hole in your wallet. ■