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ACCOUNTING FOR THE PANDEMIC: FINANCIAL REPORTING CONSIDERATIONS RELATED TO COVID-19

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Executive Summary

- The COVID-19 pandemic will impact your organization's accounting and financial reporting
- Debt restructuring and lease modifications will require special consideration
- Fair value of many assets and liabilities will be affected
- Property, plant and equipment values may not be recoverable, necessitating impairment charges
- The pandemic may represent a triggering event requiring organizations with goodwill and other intangibles to evaluate those assets for impairment
- Subsequent events disclosures will be heavily scrutinized
- Severe financial challenges will require many organizations to reevaluate their ability to continue as a going concern

The Situation

The world is in the midst of a global health pandemic. COVID-19 has claimed the lives of many and sickened even more. Governments have imposed severe measures aimed at slowing the spread of the novel coronavirus. Many businesses are restricted in their operations or temporarily closed altogether. Financial markets are in recession territory given the significant losses incurred in the first half of 2020. These restrictions have and will continue to have significant accounting and financial reporting impacts on nearly all organizations. This Accounting Advisory Alert is meant to provide a starting point for exploring how this event will affect accounting and financial reporting at your organization.

Debt

Loan Modifications

If a creditor grants concessions to a debtor that it would not otherwise consider, for economic or legal reasons, related to a debtor's financial difficulties, the debtor must account for the loan modification as a troubled debt restructuring (TDR). (The CARES Act includes relief for creditors from applying TDR accounting, subject to certain conditions, but does not include similar relief for debtors.) If a borrower determines that a loan modification is not a TDR, the change is accounted for under ASC 470-50-40, Debt – Modification and Extinguishments – Derecognition.

Covenants

In the event debt covenants are breached at the balance sheet date or before the issuance of the financial statements, the entity needs to assess whether its lender has the right to call the debt within 12 months. Amid the coronavirus pandemic, lenders may be more willing to consider covenant waivers. Any portion of debt that will have to be repaid within 12 months must be classified as a current liability on the balance sheet. This analysis is especially pertinent in the current economic climate, as many firms may find themselves facing liquidity issues or going concern questions.

Fair Value

Fair value is the price an entity would receive to sell an asset (or pay to transfer a liability) in an orderly transaction that occurs between participants in the principal market (or most advantageous market) for the asset or liability. Fair value is based on an asset's highest and best use for nonfinancial assets.

Some basic tenants of fair value are affected by COVID-19. For example, the definition states that fair value is based on orderly transactions. Firms in many industries, especially travel and oil and gas, are showing signs of financial strain. Note that distressed sales or forced liquidations are not considered orderly transactions.

Many channels that would normally be considered a principal market for a given good or service have been shut down or otherwise affected. For example, many retail storefronts are closed indefinitely in an effort to prevent the spread of the virus. It' is possible that the principal or most advantageous market may have changed as a result of COVID-19.

Further, nonfinancial assets that consider an asset's highest and best use may change if the pandemic continues for an extended period of time. For example, some cruise lines have offered their ships as temporary hospitals and some manufacturers have retooled their equipment and facilities to supply essential medical devices and personal protective equipment.

In addition to the fair value measurement impacts noted above, COVID-19 may also impact the appropriateness of the valuation method selected, as well as inputs including discount rates, credit risk, and expected cash flows.

Going Concern

Substantial doubt about an entity's ability to continue as a going concern exists if it's probable the entity will be unable to meet obligations as they become due within 12 months after the date of issuance of the financial statements. Management is responsible for evaluating at each reporting date whether substantial doubt about the entity's ability to continue as a going concern exists, and making appropriate related disclosures.

The disruption caused by COVID-19 has been widespread and unprecedented. Users of the financial statements will apply heightened scrutiny to a company's disclosures.

Potential indicators that substantial doubt exists regarding the entity's ability to continue as a going concern may include:

- Negative trends in working capital
- Sustained operating losses
- Negative cash flows from operations
- Negative current ratio
- Non-compliance with debt covenants
- Significant debt maturing in the near future
- Loss of significant customers or suppliers

Management's plans to mitigate adverse conditions or events may be considered if they can be effectively implemented. These may include:

- Reducing or delaying expenses
- Selling assets to generate cash flow
- Restructuring debt or other obligations
- Raising capital

If management determines that substantial doubt exists about the entity's ability to continue as a going concern, the main reasons and management's evaluation of those conditions must be disclosed. If management's remediation plans alleviate the substantial doubt, these plans must be disclosed in the financial statements. Alternatively, if management believes it cannot mitigate the going concern risk, that fact must be disclosed.

COVID-19 will have a significant impact on the going concern analysis. The pandemic will likely cause many companies to suffer operating losses, negative cash flows from operations or losses of significant customers or suppliers. In addition, the pandemic may limit management's ability to implement mitigation plans by making it more difficult to sell assets or raise capital, for example.

Inventory

Consumers have been panic- buying groceries, toilet paper and cleaning supplies, putting a strain on supply chains for those goods. Conversely, businesses that sell non-essential goods are struggling to move inventory.

Industries driven by consumer trends, such as fashion, may find they need to sell merchandise at deep discounts. Demand is also a relevant consideration, as consumers don't need a prom dress if there's no prom this year. And if a majority of students are still distance-learning in the fall, the typical back-to-school shopping season may be affected. Travel accessories and party supplies sales are also impacted by the lack of demand driven by the pandemic.

Even some suppliers of essential goods have been forced to dispose of inventory. Farmers have had to dump milk because cheese plants and other dairy processors are idled or don't have the ability to package product for consumer supply chains. Businesses with inventories will need to take a close look at the potential for spoilage or obsolescence as a result of the pandemic.

Subsequent Events

Subsequent events occur after the balance sheet date but before the financial statements are issued or available to be issued. There are two types of subsequent events: Type 1 events provide evidence of conditions that existed at the balance sheet date, while Type 2 events provide evidence of conditions that arose after the balance sheet date. Type 1 subsequent events are required to be recognized in the financial statements, while Type 2 subsequent events are not recognized in the financial statements, but may warrant disclosure.

Examples of subsequent events that may impact a business related to the COVID-19 pandemic are:

- Government restrictions on a business' operations, including temporary closures
- Use of a company's facilities, supplies or other resources to help mitigate the crisis
- Debt refinancing, defaults, breach of debt covenants, new debt or equity financing or bankruptcy
- New agreements or significant amendments to existing agreements

Impairment

Property, Plant and Equipment

ASC 360-10-35-21 requires that long-lived assets should be tested for recoverability when events or changes in circumstance indicate that carrying value may not be recoverable. Examples of such circumstances include adverse changes in the extent or manner in which a long-lived asset will be used. For example, some hotel operators have converted their properties to operate as temporary lodging for healthcare workers who are social distancing from their families or for the homeless.

When there is indication that carrying value may not be recoverable, an entity must apply a two-part process for determining the potential impairment. First, the undiscounted future cash flow from the long-lived asset is compared to the carrying value. If the carrying value exceeds the undiscounted cash flow, impairment exists and the second step must be applied. The impairment loss is measured as the amount by which the fair value of the long-lived asset exceeds the carrying value. The pandemic also presents unique challenges to the fair value measurement process as discussed above.

Goodwill and Other Tangible Assets

ASC 350-20-35-28 requires entities to test goodwill for impairment annually and more often if a triggering event has occurred. For many companies, economic changes related to COVID-19 may meet the definition of a triggering event, defined as an event or change in circumstance that would more likely than not reduce the fair value of a reporting unit below its carrying amount.

Changes in macroeconomic factors, industry and market data and cash flows are all examples of potential impact of COVID-19 that may represent triggering events to set off an impairment test.

Entities have the option to first perform a qualitative assessment to determine if it's more likely than not that goodwill is impaired. If there's more than a 50% chance that the reporting unit's carrying value exceeds its fair value, a quantitative assessment must be performed.

When considering impairment, it's important to first consider the potential for impairments to property, plant and equipment and other assets before testing goodwill for impairment, since the carrying value of a reporting unit is decreased by any other impairment charges first.

Revenue Recognition

In 2014, the FASB issued Accounting Standards Update 2014-09, Revenue from Contracts with Customers (ASC 606), which replaced most industry-specific revenue recognition guidance with a principles-based five-step reporting model for reporting revenues earned from contracts with customers. The standard was effective in 2018 for public companies and in 2019 for private companies.

On April 8, 2020, the FASB voted to allow private franchisors to delay implementation of ASC 606 until their annual reporting periods beginning after December 15, 2019, and interim reporting periods beginning after December 15, 2020.

The five-step model for reporting revenue under ASC 606 is as follows:

- **Step 1** – Identify customer contracts
- **Step 2** – Identify performance obligations
- **Step 3** – Determine the transaction price
- **Step 4** – Allocate the transaction price
- **Step 5** – Recognize revenue

Step 1 – Identify Customer Contracts

A customer is a party that enters into a contract with an entity to acquire goods and services that are outputs of its ordinary activities in exchange for consideration. In the wake of the coronavirus pandemic, many companies' "ordinary" activities may have changed, e.g, distillers making hand sanitizer and textiles manufacturers producing face masks. Entities should also consider whether they have new types of contracts with customers that are within the scope of ASC 606. This step also requires that entities consider termination clauses and collectability in determining whether a contract exists. With many firms experiencing financial strain due to COVID-19, these indicators of a substantive transaction may be more difficult to ascertain.

Step 2 – Identify Performance Obligations

Businesses are coming up with creative ideas to boost sales amid the pandemic. Some restaurants are throwing in toilet paper with delivery orders. Some retailers are running promotions to drive online sales. Companies should consider if these incentives represent performance obligations under ASC 606. Generally, immaterial goods or services are not required to be identified as separate performance obligations.

With physical locations temporarily closed, companies that may not be accustomed to providing shipping may now be doing so. ASC 606 addresses whether shipping and handling is treated as a separate performance obligation.

As companies adapt to the crisis, they may fill new or different roles, and must consider if they're acting as a principal or agent in a given transaction, which in turn determines whether revenue should be presented on a gross or net basis.

Step 3 – Determine the Transaction Price

The primary concern with the third step of the revenue recognition model is the impact on variable consideration. Entities are required to estimate the amount of consideration it will be entitled in exchange for transferring promised goods or services. For example:

- Manufacturers that receive additional consideration based on retail sales volume may be affected, since consumers have been panic-buying essential items and demand for non-essential items is constrained
- Live event and travel companies are dealing with an unprecedented volume of refund requests
- Retailers are modifying return policies by extending the return period for some goods, and prohibiting returns on certain items like paper products and cleaning supplies to prevent hoarding
- Construction companies may forfeit incentives or sustain penalties if projects fall behind schedule
- Service providers are waiving late payment fees and other penalties

Variable consideration is only recognized to the extent that it is probable there will not be a significant reversal in the future.

Step 4 – Allocate the Transaction Price

ASC 606 requires entities to allocate the transaction price to the identified performance obligation, generally based on the standalone selling price of the goods and services. With supply and demand disrupted across many industries, entities should consider whether standalone selling prices of goods or services may have changed.

Step 5 – Recognize Revenue

Under ASC 606, revenue is recognized when or as a performance obligation is satisfied. For revenue that is to be recognized over time, an entity must determine:

- The period over which to record the revenue; and
- The pattern in which to record the revenue

The COVID-19 crisis could affect one or both of these factors. For example, companies that sell season passes or annual memberships, including theme parks, fitness centers and museums, may need to reconsider whether it's appropriate to recognize revenue in the same pattern, given the closures that are affecting those businesses. The pandemic may also delay or limit access to materials, labor, permitting or inspections, which could impact the timing of revenue recognition.

Realizability of Deferred Tax Assets and Valuation Allowances

ASC 740 requires an entity to record a valuation allowance to reduce a deferred tax asset to a realizable amount when necessary. An entity must reevaluate the need for a valuation allowance at each balance sheet date based on current facts and circumstances. The determination of the realizability of a deferred tax asset depends on whether the entity will generate sufficient taxable income to use the tax benefit in the future.

Some of the items discussed elsewhere in this document, such as fair value and impairment, may result in new temporary differences that may need to be recorded. The coronavirus crisis may have a significant impact on the determination of whether the entity will generate sufficient future taxable income to use these deferred tax benefits.

Leases

Many retailers, restaurants and other businesses suffering financial strain as a result of the COVID-19 outbreak are seeking deferred or reduced rent payments and other concessions. The most significant lease accounting issue for entities that have adopted ASC 842 is whether such a concession should be accounted for as a lease modification or variable lease payment. There is rationale for either conclusion, and which method to apply will depend on the individual circumstances and enforceable provisions under the original contract.

For parties applying ASC 840, the rent concession must be analyzed to determine whether the revised lease payments would have resulted in a different lease classification had they existed at the inception of the agreement. If so, the modified lease is accounted for as a new contract over the remaining term, and reclassified accordingly.

On April 10, 2020, the FASB released a Q&A document acknowledging that the lease modification guidance under both standards applies to routine changes in lease terms, and does not consider the magnitude of rent concessions resulting from the pandemic. The document includes interpretive guidance to assist entities in applying either lease accounting standard. It also includes optional relief, allowing an entity to not apply lease modification guidance in both standards for lease concessions granted because of the COVID-19 pandemic that do not result in a substantial increase in the lessor's rights or lessee's obligations. Entities that use the temporary accounting policy election are required to provide incremental disclosure regarding the concessions granted or received.

Schneider Downs continues to carefully monitor accounting and financial reporting considerations related to the COVID-19 pandemic. We have published over 100 articles related to legislative changes, market conditions and business considerations brought on by the pandemic to help clients make the best decisions for their future. Stay up to date by visiting the Schneider Downs COVID-19 Resource Center at **https://www.schneiderdowns.com/covid-19-resource**.

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