Deloitte.

Financial Reporting Alert 20-5
September 11, 2020

Contents

COVID-19 Financial Reporting Trends — Different News or More of the Same?

by Eric Knachel and Jana Allen, Deloitte & Touche LLP

Introduction

The business environment is different than it was three months ago — or is it largely the same? The answer to this question may depend on your perspective. While individual companies may be in very different stages of their survival, recovery, or evolution, one thing is certain: the coronavirus disease 2019 ("COVID-19") pandemic has touched all industries and sectors, and literally no company has been immune to its impact.

Regardless of industry, financial condition, supply chain and distribution logistics, workforce composition, changing customer preferences, etc., all companies currently face a myriad of financial reporting and accounting challenges related to COVID-19. The challenges are prevalent in most companies to varying degrees.

This publication takes a strategic look at the financial reporting and accounting challenges that are top of mind for many companies as well as trending and ongoing issues. It also provides insights into different alternatives companies are pursuing in response to the challenges. Links to other Deloitte financial reporting resources that address the effects of the COVID-19 pandemic are provided throughout this publication.

Top of Mind

Forecasting

Companies continue to face challenges related to forecasting as a result of the ongoing uncertainties associated with the COVID-19 pandemic. Looking across the economic landscape, one might observe a tale of two markets: companies that are being challenged to get back to pre-outbreak operations and those that are benefiting from the outbreak.

For many of the companies negatively affected by COVID-19, we have observed the development of forecasts that use pre-COVID-19 results as an initial target on which such companies have based their assumptions for the resumption of "normal growth." However, we believe that companies should ask themselves whether achieving pre-COVID-19 results in the near term is reasonable or whether they are facing a "new normal" given the potential continuation of the existing economic environment or a permanent shift in their business models introduced by the pandemic.

In thinking about both a new normal and future trends, some companies are evaluating whether customer preferences have shifted in such a way that they most likely will not reach the same performance levels they achieved before the outbreak. Other companies that may be benefiting currently are assessing whether they will continue to outperform in future periods or revert back to historical performance.

With all the unknowns and uncertainties, including the timing and pattern of economic recovery, we have noted that more companies are preparing multiple forecasts with different recovery scenarios and are probability-weighting the likelihood of each outcome. In addition, with the increase of liquidity challenges and shortfalls of capital resources, many companies have enhanced their focus on forecasting cash position and cash flows rather than allowing cash flow estimates to be simply derived on the basis of forecasted operations.

While the approach to forecasting operations that some companies have taken leverages historical data from the 2008 financial crisis (the "financial crisis") as an appropriate benchmark, we believe that such companies should exercise caution in determining the extent to which the financial crisis is comparable to the current environment given the fundamental differences between the two economic periods. For example, the current economic environment may present a myriad of factors such as supply chain disruption, change in customer behavior, workforce adjustments, and industry-specific impacts, which were not necessarily present during the financial crisis.

While we do not believe that there is a one-size-fits-all approach to addressing the forecasting challenges that exist currently, we have seen the following strategies prove to be effective for a number of companies:

- Evaluating recovery and financial forecasts from an outside-in perspective first. Specifically, focusing on the factors, issues, and conditions outside of a company's control that are known and knowable.
- Automating components of forecasting to help remove bias and facilitate more real-time and frequent reforecasting as key drivers and trends change, while also analyzing data at a more detailed level.
- Considering facts that both support and contradict assumptions regarding the company's timing and pattern of recovery, sustainability, and growth.

Communication With Stakeholders

Transparency! When it comes to disclosure and communication, we have all heard about the importance of transparency. And in the current COVID-19 environment, the need for transparent communication is magnified.

Regarding required disclosures, many companies have unusual or nonrecurring activities related to COVID-19 that result in various expenses (e.g., restructuring, severance, impairments, modifications of stock awards). They may have also received government assistance or insurance recoveries. Companies' disclosures about these types of activities should be robust and should describe the accounting treatment used as well as how such items are presented in the financial statements.

The SEC recently emphasized the importance of robust disclosures and issued disclosure guidance related to COVID-19[1] that, among other items, encouraged registrants to disclose how a company is dealing with short-term and long-term liquidity and funding risks in the current environment, particularly if funding sources and efforts present new risks or uncertainties to a company's business. (See additional discussion of SEC reporting and disclosure.)

In the quarter ended June 30, 2020, we observed that an increased number of companies provided non-GAAP metrics[2] that included COVID-19-related adjustments. Notwithstanding that increase, we are aware of some companies that chose not to provide such non-GAAP metrics either because of concerns regarding (1) judgments related to which COVID-19-related costs were in fact "unusual or incremental" and to objectively quantifying those costs and (2) creating potential negative comparisons in future periods to the extent that certain COVID-19-related costs (or a portion thereof) become recurring costs. In still other instances, companies determined that their potential COVID-19-related non-GAAP adjustments were immaterial.

We also noted that a significant number of COVID-19-related non-GAAP adjustments were associated with activities that are often included in non-GAAP adjustments but were described as being caused by or related to the impact of COVID-19, such as impairments, write-offs, and restructuring. To a lesser degree, we also observed COVID-19-related adjustments that were described as incremental employee compensation or benefits, and incremental expenses associated with personal protective equipment, incremental cleaning, and sanitation efforts. (See additional discussions of non-GAAP measures and non-GAAP presentation issues and considerations.)

Internal Controls

Internal control environments continue to become increasingly complex as companies navigate the impacts of COVID-19. While some aspects of such environments may have changed during the COVID-19 pandemic, the requirement for effective internal controls over financial reporting (ICFR) under the Sarbanes-Oxley Act has not changed, and regulators continue to focus attention on, and emphasize the importance of, such controls. Accordingly, companies should not lose sight of what is appropriate for effective ICFR versus what may be considered "normal" or "common" practices for dealing with the challenges of the COVID-19 pandemic, if such practices are not effective.

We have seen companies continually evaluate whether their internal control environment can mitigate critical risks given the rapid changes in organizations and business operations in the current environment. Specifically, with closed locations or limited access to them,

[1] See CF Disclosure Guidance Topic No. 9, *Coronavirus (COVID-19)*, and CF Disclosure Guidance Topic No. 9A, *Coronavirus (COVID-19) — Disclosure Considerations Regarding Operations, Liquidity, and Capital Resources*.

[2] A registrant may choose to present a non-GAAP measure that makes adjustments for unusual, direct, and incremental costs attributable to COVID-19 while also presenting the most directly comparable GAAP measure with equal or greater prominence. See additional discussion of non-GAAP measures.

many companies are wrestling with challenges associated with physical inventory counts that cannot be performed as originally planned. Alternative approaches that some companies are contemplating include the deferral of cycle accounts; the use of prior cycle counts, with detailed analysis of inventory purchases and sales; and the potential use of video technology. Before pursuing changes to its original plan for physical inventory counts, a company should pay particular attention to its specific regulatory environments as well as to specific facts and circumstances related to the company, such as the nature of the inventory, and should discuss such changes with its accounting advisers. (See additional discussion of internal controls.)

As companies continue to adapt to the impacts of COVID-19, they may be exposed to a heightened level of risk related to certain areas. Two such common areas are:

- *Cyberattacks* — With the increase of remote working environments, some companies have experienced a greater volume of cyberattack attempts. Companies should ensure that their established cybersecurity controls remain functional when considering the impact of today's remote workforce.
- *Segregation of duties* — In situations in which the responsibilities for controls have been reassigned because of changes in personnel (such as layoffs or furloughs, which have become more prevalent as a result of COVID-19), companies should specifically evaluate whether appropriate segregation of duties continues to exist.

Trending

Stock Compensation Plans and Awards

In recent months, we have seen an increased level of activity related to stock compensation plans and awards. The ongoing impact of COVID-19 has led to the obsolescence of many previously established company-specific performance targets. While some companies have modified awards to revise performance targets, others have delayed the timing of granting awards, issued "off-cycle" grants, modified the strike price of existing underwater options, and extended the exercise period for awards, all presumably in an effort to ensure that stock compensation arrangements continue to provide the intended motivation for company employees and executives to work toward accomplishing company goals and objectives.

Regardless of the specific action taken, modifications of stock awards can lead to a host of accounting challenges and consequences. For example, when revising performance targets, companies need to be mindful that the performance conditions are sufficiently objective and determinable; otherwise, an award may not be considered "granted," leading to variable and potentially increased expense if compensation cost must be recorded before the grant date is established. In addition, when modifying stock awards, companies need to consider whether such awards were expected to vest before the modification and, if so, whether the modified awards provide incremental value to the recipients. Further, companies that grant stock options or similar awards will need to consider recent market volatility when valuing their stock awards and the related compensation expense to be reported. (See additional discussion of stock compensation.)

Leases

In connection with optimizing their real estate footprint on a go-forward basis, a number of companies are reevaluating their leases or lease portfolios. From an accounting standpoint, companies should consider whether a decision to no longer use a leased asset constitutes an abandonment of the asset. Accounting guidance generally requires a company to accelerate expense recognition for assets deemed "abandoned." However, to be deemed abandoned, a company needs to assess whether it has the ability and would be willing to sublease the leased asset at any point during the remaining lease term. This may include considering the economic environment and the expected demand in the sublease market and will likely require a company to use more judgment when assessing longer remaining lease terms. The potential that a company would be willing to sublease an asset at any point in the future may preclude the company from considering an asset to be abandoned and thus preclude the acceleration of expense recognition.

COVID-19 Versus LIBOR Modifications for Financial Instruments

With the anticipated transition away from the use of the London Interbank Offered Rate (LIBOR) and certain other reference rates, the FASB has provided temporary relief for contract modifications and hedging requirements under U.S. GAAP. However, an entity's eligibility to use the relief would be precluded for any modifications not related to the replacement of a reference rate that could affect the amount or timing of contractual cash flows. While we anticipate additional modifications of financial instruments related to COVID-19 impacts, companies should be mindful of the potential accounting ramifications if contract modifications encompass both adjustments for removing LIBOR and other modifications. In addition, we expect that some companies may consider strategically separating the timing of any reference rate from COVID-19 modifications to ensure their eligibility for the FASB's relief related to reference rate reform. (See additional discussion of reference rate reform.)

Default Risk on Modified Financial Instruments

As in prior months, we have observed modifications made by lenders to defer or delay the payment of principal or interest on outstanding loans for a certain period (a "payment holiday"). Some companies have experienced challenges with assessing default risk and the likelihood that the counterparty will comply with the contractual terms after these payment holidays. As these modifications for payment holidays or additional relief come to an end, companies should evaluate whether there are new or continued indicators that the debtor may be experiencing financial difficulties even though the debtor is not currently in payment default for the previous modifications.

Employee Retention Credit

In the past several months, many companies have applied for the Employee Retention Credit (ERC) offered under the Coronavirus Aid, Relief, and Economic Security (CARES) Act. An application for the ERC can be filed retroactively for prior periods and, accordingly, we expect to continue to see a number of companies pursue this form of government assistance. While the ERC is designed to broadly apply to all companies, understanding the eligibility criteria may not be intuitive, particularly on the basis of a quick read of the appropriate CARES Act provisions.

To be eligible for the ERC, companies need to either (1) fully or partially suspend operations during any calendar quarter in 2020 as a result of governmental orders that limit commerce, travel, or group meetings or (2) experience a significant decline in gross receipts during a calendar quarter. But what does this really mean? The Internal Revenue Service has provided over 90 Frequently Asked Questions to help companies and their advisers understand the eligibility criteria along with how to compute the ERC amounts to be claimed.

Simply stated, we believe that the majority of companies are eligible for the ERC. We have observed, however, that determining the amounts to be claimed and developing an appropriate analysis supporting the ERC are the more challenging aspects most companies face related to this credit. (See additional discussion of the ERC.)

Ongoing

While some COVID-19-related issues may be characterized as "ongoing," such categorization is not intended to diminish the significance or pervasiveness of the matter. Rather, it merely acknowledges that many of the COVID-19-related issues that companies currently face also existed in prior periods.

Goodwill and Long- and Indefinite-Lived Asset Impairments, Realizability of Deferred Tax Assets, and Going Concern

Although some companies are continuing to see the recovery of their share price, they must still assess the potential need for impairment charges, which includes considering broad economic indicators in addition to their specific facts and circumstances. In that same spirit, certain companies may need to increase their focus on the future realizability of deferred tax assets, along with their ability to continue as a going concern, as a result of significant incurred and projected losses. (See additional discussions of impairments, income taxes, and going-concern considerations.)

Layoffs, Furloughs, and Other Restructuring Activities

Since many government-supported employment programs are scheduled to expire shortly, companies are continuing to contemplate various restructuring activities and could potentially undergo employee terminations and other reorganizational activities. In addition, companies continue to face operational challenges due to supply chain disruptions and health concerns, resulting in idle production capacity and vacant facilities along with the related financial statement impact. (See additional discussions of employee termination benefits and exit or disposal costs.)

Modifications of Contractual Agreements

Many companies continue to renegotiate the terms of existing contracts and arrangements as part of addressing the impact of COVID-19. The most frequent examples include leases, contracts with customers, and the terms of financial arrangements. Of particular note, if companies encounter even further delays in the timing of forecasted transactions designated as hedged items, they may experience additional pressure related to whether forecasted transactions will still occur within a reasonable period.

Government Assistance and Insurance Recoveries

We continue to see many companies receive different forms of government assistance along with insurance recoveries. Under the Paycheck Protection Program in the CARES Act, a number of companies have accounted for monies received as debt rather than a government grant because of the uncertainty associated with the repayment of such funds. (See additional discussions of the CARES Act and insurance recoveries.)