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# COVID-19 and Financial Reporting Trends — Accounting for the Pandemic in the Current Quarter

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## Introduction

To say that financial reporting for the most recent quarter was challenging is an enormous understatement. Companies faced government-mandated shutdowns, supply chain disruptions, implications of the CARES Act,<sup>1</sup> and more. At the same time, they had to figure out how to close their books while their employees worked remotely — oh, and manage operations, too!

What financial reporting issues lie ahead given what we have learned from that quarter? What accounting topics are likely to be trending? Why are those topics trending? What tension points will be associated with those trending topics?

This publication takes a strategic look at what are likely to be the most common hot topics for the current reporting quarter. Links to other Deloitte [financial reporting resources](#) that address the effects of the coronavirus disease 2019 (“COVID-19”) pandemic are provided throughout this publication.

## Forecasts

As a result of the ongoing uncertainties associated with the unprecedented nature of the COVID-19 pandemic, companies are likely to continue to face challenges related to developing assumptions and estimates for assessing the recoverability of nonfinancial assets (including goodwill), determining the realizability of deferred tax assets (DTAs), and assessing their ability to continue as a going concern.

<sup>1</sup> The Coronavirus Aid, Relief, and Economic Security Act.

The most recently completed reporting period was the first in which most entities incorporated the effects of COVID-19 into their budgeting and recoverability analyses, and some may have felt as though they were shooting in the dark. Has uncertainty finally been removed? Certainly not! But many companies are revisiting their forecasts as the business landscape continues to evolve.<sup>2</sup>

Effective COVID-19 forecasting includes reforecasting as frequently as needed. How often? One determining factor is likely to be the timing of the availability of new information that is deemed important to the forecast models or when new drivers are identified. As the chances for a V-shaped recovery fade, many economists believe that a U- or a W-shaped recovery is more likely.<sup>3</sup> Companies often use different scenarios as part of their forecasting process.

While the effects of COVID-19 are broad, not all industries and not all companies within a specific industry are expected to be affected similarly. The pandemic's effect on a company may be based on factors such as the products and services it offers, its supply chains, the availability of government assistance, actions it has taken in response to the pandemic, and its financial strength at the pandemic's outset. In addition, evolving factors such as new economic data, easing of lockdowns, continued work-at-home directives, and consumer behavior and preferences are likely to significantly affect a company's outcomes. Monitoring early indicators that differentiate those scenarios will be particularly important as companies seek to adapt their forecasts to the evolving COVID-19 business environment.

## Goodwill and Long- and Indefinite-Lived Asset Impairments

When events or changes in circumstances indicate that it is more likely than not that an asset is impaired, a company is required to test it for impairment even if the asset must also be tested annually for impairment (e.g., goodwill and indefinite-lived intangible assets). In the current reporting period, a company is expected to continue to contemplate the potential effects of COVID-19 on the impairment of its assets, which includes considering broad economic indicators as well as its specific facts and circumstances such as its industry, its geographic areas of operation, its "cushions" (excess of fair value over carrying amount), and the actions it has taken or expects to take in response to the pandemic. While companies must routinely use judgment when testing assets for impairment, their need to use such judgment is amplified given:

- The novelty of the pandemic and its impacts on business, consumer demand, and government actions (e.g., modeling the impacts of limitations related to travel, stay-at-home directives, the CARES Act).
- The impact of events and changes in circumstances that occur after the date used to test assets for impairment.
- Indications of value evidenced by market capitalization in periods of volatility.

Companies will be expected to continually monitor assets for indicators of impairment, to reach well-reasoned judgments based on their particular facts and circumstances, and to disclose their significant judgments and estimates. They should also disclose assets deemed to be at a heightened risk of impairment even if no impairment was recognized in the current reporting period. (See additional [impairment](#) discussion.)

## Deferred Tax Assets — Valuation Allowance

Companies will need to assess their ability to realize DTAs before their expiration. Adjustments to forecasted income (like those assumed for other impairment analyses), including **forecasted future losses**, will need to be factored into that realizability assessment. Current and forecasted futures losses, particularly those that result in a cumulative loss or the

<sup>2</sup> See, for example, the *Wall Street Journal's* article on [financial scenario planning](#).

<sup>3</sup> See, for example, the *Wall Street Journal's* articles on a [survey of economists](#) and forecasts about the [speed](#) and [shape](#) of recovery.

**expectation** of a cumulative loss, may raise significant concerns regarding a company's ability to use DTAs and, therefore, result in the recognition of a related valuation allowance. (See additional [income taxes](#) discussion.)

## Going Concern

The potential prolonged disruption caused by COVID-19 may raise concerns about whether a company is able to continue as a going concern within one year after the date on which financial statements are issued. Companies will need to consider the following among other factors:

- Changes in forecast results.
- Potential liquidity and working capital shortfalls.
- Their ability to access capital.
- Contractual obligations.
- Diminished demand for products and services.

In addition, management must consider whether its plans, including potential government assistance, are able to mitigate the negative impacts on its business. While the effects of COVID-19 may be greater in certain industries (e.g., airlines, travel, hospitality), the current economic environment has significantly strained the ability of a number of companies to develop sustainable business models. (See additional [going-concern](#) discussion.)

## Modifications to Contractual Arrangements

Given the timing of the COVID-19 outbreak and related government mandated or voluntary shutdowns, only a relatively small number of contractual arrangements were changed or terminated before March 31, 2020. We have observed that after March 31, however, many companies modified contracts as part of addressing the reality that the impact of COVID-19 will be prolonged. In a number of cases, changes to existing contractual arrangements raise accounting questions about whether such changes should be accounted for prospectively or at the time of change. Questions also arise in connection with changes to contractual terms, such as whether the changes (1) represent a new contract, (2) affect other existing contracts, or (3) affect accounting policies related to contracts executed in the future. We have observed a significant increase in changes to contractual terms associated with the topics discussed below.

## Leases

In the wake of COVID-19, many companies have made changes to various lease terms (e.g., timing of payments, amount of payments, duration of agreements). In addition, the FASB has provided relief related to the accounting for rent concessions resulting from the pandemic. Under such relief, instead of evaluating all concessions individually to determine whether they represent lease modifications, companies may choose to account for eligible concessions as lease modifications or apply various alternative models. The application of modification accounting to a large portfolio of leases can be particularly challenging because it involves the reallocation of consideration, the reassessment of lease classification, and the remeasurement of lease-related assets and liabilities. While the alternative models are expected to simplify the accounting analysis required for concessions, the selection of any one particular alternative model may result in amounts of lease expense and lease liabilities for lessees (and lease revenue and lease receivables for lessors) that differ from those applied under the lease modification framework and other acceptable alternatives models. As a result, companies must provide specific disclosures related to material concessions granted or received.

In addition, lessees may be required to test right-of-use-assets for impairment as a result of business closures, supply chain disruption, or other consequences of the pandemic that negatively affect the future cash flows expected to be derived from the use of the underlying property, plant, and equipment. (See additional [leases](#) and [rent concessions](#) discussions.)

## **Revenue Contracts**

Some companies may seek to mitigate the effects of the pandemic by offering features such as price concessions, discounts on the purchase of future goods or services, free goods or services, extended payment terms, extensions of loyalty programs, opportunities to terminate agreements without penalty, or revisions to purchase commitments.

If revisions are made to a revenue contract, significantly different reporting outcomes may result depending on the nature of the changes. Companies must consider the specific facts and circumstances of changes in contractual terms (including their business practices and communications with customers) to determine whether to account for the impact of such changes at a single point in time (e.g., the quarter ended June 30, 2020) or over a longer period. (See additional [revenue](#) discussion.)

## **Payment Terms of Loans or Debt Restructurings**

### ***Borrowers***

Continued liquidity pressures related to COVID-19 have led to a greater number of debt restructurings (e.g., to extend maturity dates, reduce interest rates, ease covenant terms). Companies will need to determine whether changes to existing loans should be accounted for as a troubled debt restructuring (TDR), a modification, or an extinguishment, all of which have specific individual disclosure requirements.

### ***Lenders***

Lenders are increasingly modifying loan receivables to temporarily defer or delay the payment of principal or interest or to reduce the interest rate on loans. Lenders that apply specific provisions of the CARES Act or other applicable regulatory provisions may choose to not treat certain short-term payment modifications as TDRs. In these situations, and as long as the modification does not result in a new loan for accounting purposes, the FASB has provided interest income recognition relief to lenders. Specifically, if a lender does not require payment of the principal or interest for a certain period (“a payment holiday”) and certain other criteria are met, companies may choose among equally acceptable accounting alternatives. In simplified terms, companies can elect to record no interest income or continue to record interest income on a blended-yield basis during such a “payment and interest accrual holiday.” Specific disclosures will be required about the selection of either accounting policy. (See additional [forgivable loan](#) and [financial instruments](#) discussions.)

## **Cash Flow Hedges — Forecasted Transaction Timing Modification**

Under existing accounting guidance, gains or losses on a qualifying cash flow hedge of a forecasted transaction may be recorded outside of earnings as long as a company believes that it remains probable that the forecasted transaction will occur. While the guidance indicates that only in “rare cases”<sup>4</sup> is it expected that hedging gains and losses would not be reclassified into earnings if it is still probable that a delayed forecasted transaction will occur more than two months after the original forecasted period, the FASB has indicated that the effects of COVID-19 qualify as a “rare case.”

<sup>4</sup> Only in rare cases is it expected that amounts recorded in accumulated other comprehensive income (AOCI) related to a terminated cash flow hedging relationship should remain in AOCI if it is still probable that a delayed forecasted transaction will occur more than two months after the original forecasted period.

Nevertheless, a company needs to exercise significant judgment and consider the specific facts and circumstances of its forecasted transactions to determine whether (1) delays in the timing of the forecasted transactions were related to the effects of COVID-19 and (2) it is still probable that a forecasted transaction will occur. (See additional [hedge accounting](#) and [financial instruments](#) discussions.)

## Collectibility

Companies may have collectibility problems as a result of widespread business disruptions, financial difficulties, and liquidity issues. As discussed below, concerns related to collectibility extend beyond simply estimating how much cash will be collected.

## Accounts Receivable and Revenue Recognition

An amount may be deemed uncollectible for several reasons, such as credit risk or adjustments in the transaction price (e.g., price concessions, rebates, discounts). While differentiating between credit risk and adjustments in the transaction price may not affect the overall outcome of the collectibility analysis (and thus the estimated value of accounts receivable), the presentation of such amounts could differ significantly (i.e., recording bad debt expense vs. reduction of revenue) along with the related disclosure requirements depending on the deemed underlying cause (e.g., credit risk vs. price concession) of the collectibility concern.

Collectibility concerns about new, in-process, or fully completed customer contracts may limit the amount of revenue that can be recognized on existing and future contracts. Further, companies may determine that as a result of collectibility concerns, an enforceable contract does not “exist” (as defined in the applicable literature) and thus that they are precluded from recognizing revenue at all, even if they have fulfilled certain obligations under the contract. In such instances, companies will need to further evaluate the criteria for revenue recognition since the timing of recognizing revenue may be disconnected not only from a company’s performance under the contract but also from its receipt of cash. (See additional [revenue](#) discussion.)

## Lessor Considerations

A lessor’s agreement to give a lessee a concession, regardless of its form, is not an *automatic* indicator that collection of lease payments from that lessee is no longer probable. Conversely, a lessee’s need for a concession, coupled with the economic downturn that many sectors are experiencing, may be relevant in the lessor’s collectibility assessment. In addition, if a lessee does not pay or only partially pays a lessor and that short pay is neither formally accepted as a concession nor allowable in the original agreement, it may be a negative indicator in the lessor’s collectibility assessment. (See additional [leases](#) and [rent concessions](#) discussions.)

## Restructuring, Disposal Costs, and Government Assistance

The pandemic’s prolonged impact has led companies to take proactive measures to sustain operations, such as seeking government assistance or other forms of relief and contemplating various restructuring activities.

## Employee Terminations

Common measures that many companies have taken in response to the pandemic include implementing the terms of an existing termination plan, granting furloughs or temporary layoffs, offering one-time employee termination or relocation benefits, providing compensated absences, or a combination of these or different benefits and plans. Depending on the specific terms and conditions of such arrangements, costs and or liabilities may be incurred that span several reporting periods or present unique accounting challenges. The period in

which expenses are reflected for financial reporting purposes may vary from one company to another, as well as within a company, depending on the types of plans and benefits offered. (See additional [employee termination benefits](#) discussion.)

## **Exit or Disposal Costs**

Plans initiated by companies to address the pandemic may include facility closures, disposals of equipment, or sales of buildings. Since such plans may take the form of immediate disposition or continued partial operations until the time of disposal, they give rise to questions about the timing of when costs should be recognized, the amount of costs to be recognized, and the presentation of those costs, all of which depend on the specific facts and circumstances associated with the activity. (See additional [exit or disposal costs](#) discussion.)

## **Government Assistance and Insurance Recoveries**

Many aspects of the CARES Act present companies with a broad range of financial reporting challenges. Companies will need to determine the accounting guidance and policies to apply related to government assistance received as well as the appropriate timing for recognizing such government assistance (which may not correspond to the timing of cash received under the CARES Act), presentation, and disclosures. Also, companies should monitor subsequent clarifications to the various aspects of the CARES Act along with potential new government mandates or orders.

Companies may also have insurance coverage for actions such as suspended operations, event cancellations, costs associated with increased medical claims, asset impairments, or shareholder litigation. Insurance recoveries are inherently uncertain and involve significant estimation, and the accounting model to apply may differ significantly depending on whether the insurance recoveries are related to actual costs incurred (e.g., probable of recovery), potential lost profits (e.g., a gain contingency), or a combination thereof. As a result, the timing of recording insurance recoveries, their presentation, and the required disclosures may vary greatly. (See additional [CARES Act](#) and [insurance recoveries](#) discussions.)

## **Communication With Stakeholders**

A recurring theme of the myriad of financial reporting issues associated with COVID-19 is the need for robust and transparent disclosure and communication. Given the rapidly evolving economic impact of the pandemic, management should consider how it can provide timely updates to investors regarding the pandemic's current and future effect on the company.

## **Disclosures, SEC Filings, and Press Releases**

As a result of the pandemic, SEC registrants have made, and are likely to continue to make, changes to various footnotes within the financial statements as well as other parts of their SEC filings, including risk factors, MD&A, description of the business, disclosure controls and procedures, and internal control over financial reporting. Within MD&A, as well as in press releases and other forms of communication, companies may consider adjustments to their non-GAAP measures and other metrics.

When providing non-GAAP measures, registrants should be particularly mindful of presenting the most directly comparable GAAP measure with equal or greater prominence and of including a quantitative reconciliation between the relevant GAAP and non-GAAP measures. Registrants should also ensure that the usefulness and purpose of non-GAAP measures are described, that they are not presented in a misleading way, and that they are clearly described and labeled as non-GAAP. While the SEC may not object to a non-GAAP measure that adjusts for unusual items (e.g., restructuring charges), measures that adjust revenues or eliminate recurring cash operating expenses may be viewed as potentially misleading and therefore may be prohibited. Accordingly, a registrant may choose to present a non-GAAP measure

that adjusts for unusual, direct, and incremental costs due to COVID-19 as well as any related economic uncertainty, such as assets or goodwill impairments. (See additional [non-GAAP measures](#) discussion.)

For most companies, discussion of the inputs and assumptions used in developing forecasts and other critical accounting estimates will be an increased area of focus along with the selection of any new accounting policies allowed in light of the pandemic. Other companies will determine that enhanced discussion of trends related to their liquidity position and any associated debt covenants are of utmost importance.

Further, quantitative and qualitative information regarding estimated credit losses, and disclosure of the current and expected future adverse effects of the pandemic that were incorporated into a company's estimate of expected credit losses, are expected to become more prevalent and be of increased interest to investors. (See additional [SEC reporting and disclosure](#) discussion.)

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