

Accounting and Disclosure Issues After a Natural Disaster

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Learning Objectives

- Recall the accounting and disclosure implications of natural disasters
- List important considerations related to gain and loss contingencies

Background

- Floods, wildfires, hurricanes and more natural disasters impact entities on a regular basis
- A wide range of accounting and disclosure implications can result

Potential Natural Disaster Impact

- Buildings or other assets may be damaged
- Operations may be affected by the loss of a significant supplier or customer
- Projected cash flows may change, impacting financial performance

Asset Impairment

ASC 326 Customer Receivables

- Write-offs or additional reserves may be necessary
- Allowance for credit loss is updated each reporting period based on historical experience, current conditions, and reasonable supportable forecasts

ASC 606 Revenue From Contracts With Customers

- If an entity continues to sell products and services to a customer when collectibility is not probable, revenue may not be able to be recognized on any new transactions with that customer
- Modification of terms of contract
- Reversal of cumulative income recognized

Financial Instruments – Equity Securities

- Equity investments with readily determinable fair value
 - Fair value measurement, with changes in net income
- Equity investments that qualify for ASC 820 net asset value (NAV) practical expedient
 - NAV measurement, with changes in net income

Financial Instruments – Equity Securities

- Equity investments where neither of other two options appropriate, may elect to use a modified “cost-basis” approach
 - Measure at cost, less any impairment, plus or minus changes resulting from observable price changes in orderly transactions for identical or a similar investment of the same issuer

ASC 330 Inventory

- Inventory physically destroyed should be written off
- Inventory that is damaged may be sold for scrap and should be written down to its net realizable value
 - Or market value if LIFO method used

ASC 360, Property, Plant, and Equipment

- Evaluate an asset or group of assets whenever events or changes in circumstance indicate that carrying amount may not be recoverable
- Examples of triggering events include:
 - Significant adverse change in the extent or manner in which the asset is being used or in its physical condition
 - Significant adverse change in the business climate
- Evaluate at the “asset group” level, which may be an individual asset

Finite-Lived Intangible Assets

- Economic, legal, or contractual factors cause a finite life to amortize asset over
 - E.g., patent with legal life of 20 years, but competitive advantages terminate after 5 years, is amortized over 5 years
- Estimated useful life periodically reviewed
- Impairment test same as long-lived tangible assets (e.g., PP&E) based on recoverability test

When is a door not a door?

- When it is ajar...

ASC 350 Focus on Indefinite-Lived Intangible Assets

- Annual test minimally, but also triggered when more likely than not that impairment exists
- Evaluate at the unit of account level, which may be an individual asset
- One step: Lower of carrying amount or fair value emphasized

ASC 350 Focus on Goodwill

- Annual test minimally, but also triggered when more likely than not that impairment exists
 - Unless elect to evaluate at reporting period end under nonpublic entity alternative
- Evaluate at the reporting unit level
 - Unless elect entity-level evaluation under nonpublic entity alternative to amortize goodwill
- One Step: Lower of carrying amount or fair value emphasized

General Order of Impairment Testing

1. Current assets (e.g., accounts receivable, inventory, financial assets, etc.)
2. Indefinite-lived intangible assets
3. Long-lived tangible assets held and used
4. Finite-lived intangible assets
5. Goodwill

Overview of Contingency Accounting

Contingency Defined

- An existing condition, situation, or set of circumstances:
 - Involves uncertainty with possible gain or loss
 - Will ultimately be resolved when one or more future events occur or fail to occur
- Likelihood of future event(s) ranges from remote (slight) to probable (likely)
- Financial impact ranges from reasonably estimable or not

Gain Contingencies

- A contingency that might result in a gain usually should not be reflected in the F/S:
 - May result in revenue recognized prior to realization
- Adequate disclosure may be made of a possible gain contingency, but care should be exercised to avoid misleading implications as to realization likelihood

Conditions for Loss Contingency Accrual

1. Information available before F/S issued, or are available to be issued, indicates that it is probable that asset has been impaired or liability has been incurred at the F/S date:
 - Date of F/S = End of the most recent accounting period for which F/S are being presented
 - Implicit in this condition is that it must be probable that one or more future events will occur confirming the fact of the loss
2. The amount of the loss can be reasonably estimated

If Loss Not Reasonably Estimated

- If loss not accrued because cannot be reasonably estimable:
 - Charge to income in the period when it can be reasonably estimated
- Do not charge retroactively to an earlier period:
 - i.e., do not charge some to income and others to retained earnings as prior period adjustments

Disclosure -- Loss Accruals

1. Nature of accrual:
 - Use terms like “estimated liability” or “liability of an estimated amount”
 - The term “reserve” should not be used, which is limited to an amount of unsegregated assets held or retained for a specific purpose
2. The amount accrued, in some circumstances
3. Indicate that it is at least reasonably possible that a change in an estimate of a probable liability could occur in the near term

Disclosure – Unrecognized Contingencies

- If at least a reasonable possibility that a loss or an additional loss may have been incurred and either of the following exists:
 - Amount not reasonably estimated
 - Exposure to loss exists in excess of amount accrued at lowest end of range
- Disclose the following:
 - Nature of the contingency
 - Estimate of the possible loss or range of loss or statement that such an estimate cannot be made

Losses After F/S Date

- If arises after F/S date, but before issued, accrual is not required
- Disclosure may be necessary to keep F/S from being misleading:
 - Nature of loss or loss contingency
 - Estimate of the amount or range of loss, or statement that such an estimate cannot be made

Pro Forma of Subsequent Loss

- If amount cannot be reasonably estimated, disclosure may best be made by supplementing the historical F/S with pro forma financial data giving effect to the loss as if it had occurred at the F/S date:
 - May be desirable to present pro forma statements, usually balance sheet only, in columnar form on the face of the historical F/S

How do you make antifreeze?

- Steal her blanket....

Insurance

Property & Casualty Insurance

- Claims involving fixed assets should be analyzed using a loss recovery model
- Do not book a receivable if coverage is in dispute or the policy is unclear on coverage amount
- If recovery is probable, recognize a receivable not to exceed the related loss
 - Any amount in excess should be accounted for as a gain contingency not recognized until realized or realizable

Factors to Consider When Booking a Receivable

- Terms of the agreement with the insurance carrier
- Viability of the insurance carrier
- Prior claims history with the insurance carrier
- Whether the claim is being disputed
- The amount of loss that has already been recognized in the financial statements

Key Points

- Exposure to risks does not mean that an asset has been impaired, or a liability has been incurred
- An impairment or loss may be recognized in one period
 - While the associated insurance recovery may be recognized in a later period

Business Interruption

- Policies generally cover monetary losses due to periods of suspended operations when a covered event occurs
- Record a recovery when realization of the claim is probable
 - Policy covers loss and is not in dispute

Evaluating Gain Contingency

- Ensure any contingency related to amount of coverage is resolved
- Gain is not recognized prior to insurance carrier acknowledging coverage and communicating the final amount
- A statement of “pending final review” may indicate a claim is not realizable
- Even if payment received, must evaluate for expectation of repayment or refund

Personal Injury Claims

- Recognize loss when probable and reasonably estimable under ASC 450
- Recognize recovery when:
 - Loss has been accrued
 - Policy covers loss and it is not in dispute
 - Realization is probable
- Recognize a gain contingency in excess of amount of loss when realizable

Key Points About Classification

- Recoveries should never be reflected as a reduction of cost to rebuild or replace insured assets
- Business interruption insurance recoveries should not be presented as revenue from contracts with customers
 - Even if based in part on lost revenues

Statement of Cash Flows

- Classify based on nature of the insured item to which the recovery relates
 - Rather than how the company plans to use the proceeds
- E.g., classify proceeds from damaged fixed assets as an investing activity inflow
- E.g., classify proceeds from lost inventory or business interruption as an operating activity inflow

Debt and Liquidity Issues

Background

- Entities may need to seek additional financing or amend terms of credit agreements
- A credit agreement may require a borrowing capacity equal to the outstanding balance of its eligible accounts receivable and inventory
 - Borrowing capacity may be limited, while operating expenses continue
 - A temporary or permanent increase in borrowing capacity may be necessary

Debt Covenant Compliance

- Liquidity issues may result in noncompliance with debt covenants
- Arrangements may be backed or collateralized by damaged or destroyed assets, which may trigger a default
- Debt may be “puttable” at the balance sheet date due to a covenant violation and require current classification

Subjective Acceleration Clauses

- Lender can accelerate payment if the borrower experiences a material adverse change (MAC)
 - E.g., liquidity issues or recurring losses
 - Substantial doubt about going concern disclosures may lead to acceleration
- Likelihood of acceleration impacts classification
 - If probable based on facts and circumstances at balance sheet date, classify as current
- Disclosure of risk or uncertainty may be needed, regardless

Troubled Debt Restructuring

- The creditor grants a concession to the debtor that would not otherwise consider
 - For economic or legal reasons related to the debtor's financial difficulties
 - E.g., going concern uncertainty, bankruptcy, currently in default of debt, etc.
- Generally, a borrower that can obtain funds from sources other than the existing lender at market interest rates at or near those for nontroubled debt does not meet the requirement of a TDR

Government Assistance and Relief

Background

- Both companies and nonprofit organizations may receive various forms of assistance
 - Differentiate “government” vs. “private” assistance
- Must monitor for compliance with terms or administrative requirements imposed by the resource provider
 - E.g., may be able to only use proceeds for a specific purpose
 - E.g., may need to follow specific guidelines for procuring goods and services

Nonprofit Organizations

- ASC 958-605 provides guidance for recognizing revenue for nonexchange transactions
- Recognize revenue when any “conditions” have been substantially met
- If there is a grantor-imposed restriction, consider the impact on net asset classification
- Present grant income on a “gross basis” as grant revenue or other income

Business Entities

- Absent specific guidance, ASC 105 directs financial statement preparers to follow guidance for similar transactions or nonauthoritative guidance from other sources
 - Some businesses use ASC 958 by analogy
 - Some businesses use IAS 20, Accounting for Government Grants and Disclosure of Government Assistance

IAS 20

- Recognize revenue when there is reasonable assurance that:
 - the entity will comply with the conditions, and
 - The grant will be received
- May use a systematic basis over periods in which related expenses/losses which are intended to be compensated for are recognized
- Grant income may be separately reported as “other income” or deducted from the related expense

What About FEMA Awards?

- FEMA public assistance for damages to facilities, equipment, or inventory will need to consider the intertwined benefits of FEMA grants and insurance coverage
 - FEMA subsidizes other forms of financial assistance
- Apply ASC 610-30, *Gains and Losses on Involuntary Conversions*
 - Clarifies the accounting for involuntary conversions of nonmonetary assets (such as property or equipment) to monetary assets (such as insurance proceeds)
 - Examples are total or partial destruction or theft of insured nonmonetary assets and the condemnation of property in eminent domain proceedings

Involuntary Conversions

- To the extent the cost of a nonmonetary asset differs from the amount of monetary assets received, recognize a gain or loss
 - Recognize even though an entity reinvests or is obligated to reinvest the monetary assets in replacement nonmonetary assets
- Classify the gain or loss considering ASC 220-20 related to unusual or infrequently occurring items
- Subsequently acquired nonmonetary assets are measured at cost

Why did the boy take a ladder to school?

- It was a high school...

Other Matters

Lease Terminations

- Leased property may become destroyed or not longer usable
- Terms of the lease dictate the accounting
 - If the lease terminates, lessee removes the right-of-use asset and the related liability with any difference being a gain or loss on early termination of the lease
 - If the lessee continues responsibility, reevaluate the lease term based on:
 - Rights that always existed
 - Rights that may have been modified to provide relief

Key Points About Leases

- Lease agreements may not be specific about what constitutes a natural disaster
- If a lease modification, then lease accounting will be revisited for the new lease

Idle Capacity & Vacant Facilities

- Prolonged power outages, fuel shortages, etc. may result in idle production capacity
 - May impact fixed overhead allocations
- Allocation to inventory of fixed production overhead costs is based on “normal capacity”
 - Allocation may not be increased due to idle plant or abnormally low production
- Abnormal costs are recognized in current period outside of cost of inventory
- Do not cease depreciation unless permanently abandoned

Environmental Obligations

- Determine whether new exposures to environmental remediation liabilities
 - Recognize when probable loss incurred AND
 - Amount of loss can be reasonably estimated
- Disclosure of possible loss or exposure may be required, even if a liability is not recognized

Internal Control Considerations

- Entities may temporarily or permanently relocate
- Accounting records may be damaged
- Significant unusual transactions not routine
- Key personnel may be unavailable
- May have to outsource or use independent contractors for certain functions
- Greater risk of cyberattacks as IT staff are diverted to system rebuilding
- Backup systems may be vulnerable

Risk and Uncertainty Disclosures

ASC 275, Risks and Uncertainties

- Disclose risks and uncertainties that could significantly affect the reported amounts
 - In the near term or the near-term functioning of the reporting entity
 - E.g., cybersecurity threats, natural disasters, pandemics, etc.

Concentrations of Risk

- Disclose a current vulnerability due to certain concentrations if:
 - The concentration exists at the date of the financial statements
 - The concentration is known to management at the time the financial statements are issued or available to be issued, rather than simply a wide range of possible concentrations based on general knowledge
 - The concentration makes the entity vulnerable to severe near-term impact
 - It is at least reasonably possible that the events that could cause the severe impact will occur in the near term

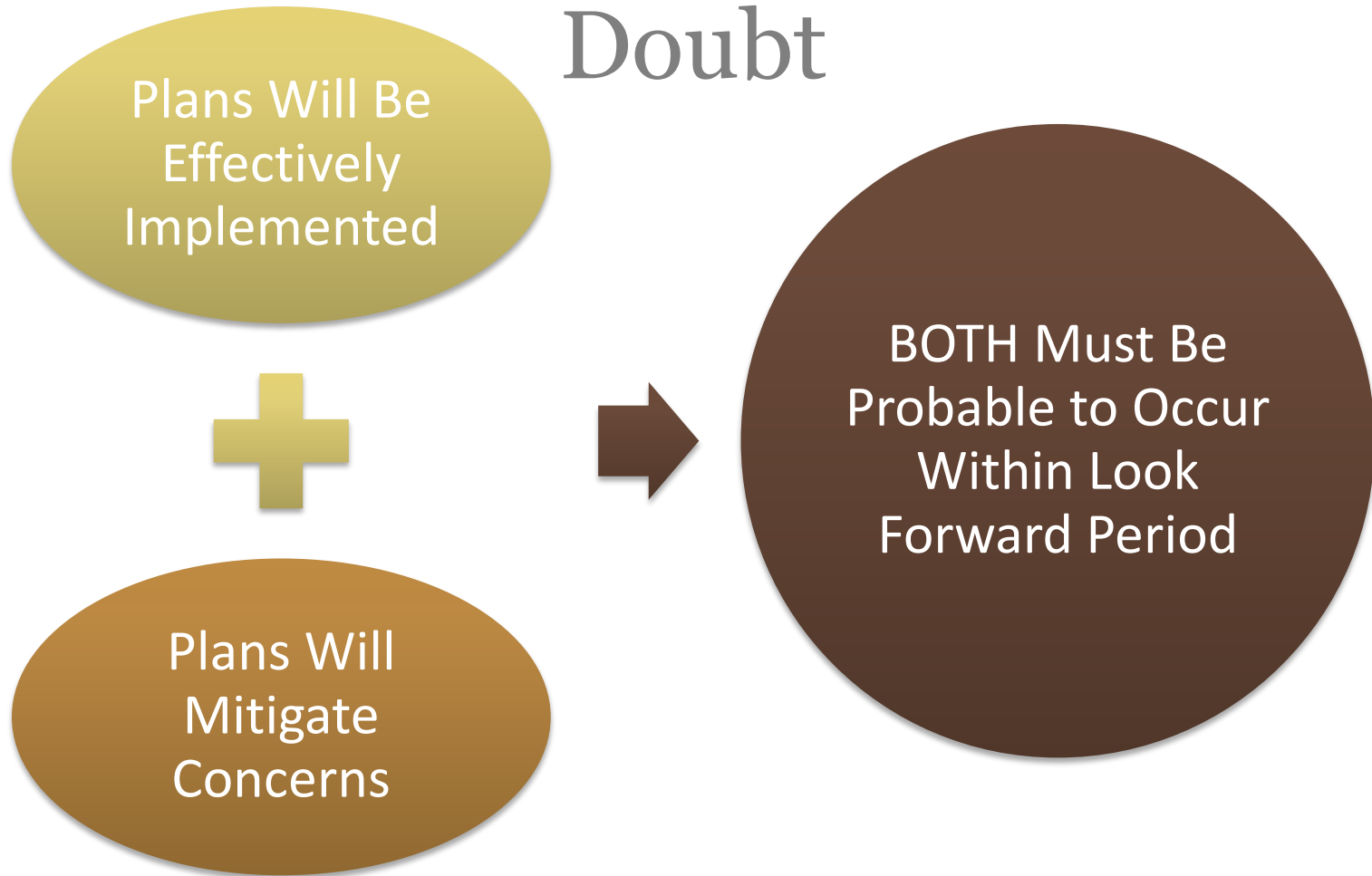
Example Common Risk and Uncertainty Disclosures

- Losses incurred, insurance claims made, and expected recoveries
- Disputes related to insurance claims and recoveries
- Quantified impact of the natural disaster on current operations
- Estimated impact and duration on future periods
- Significant effect on supply chain

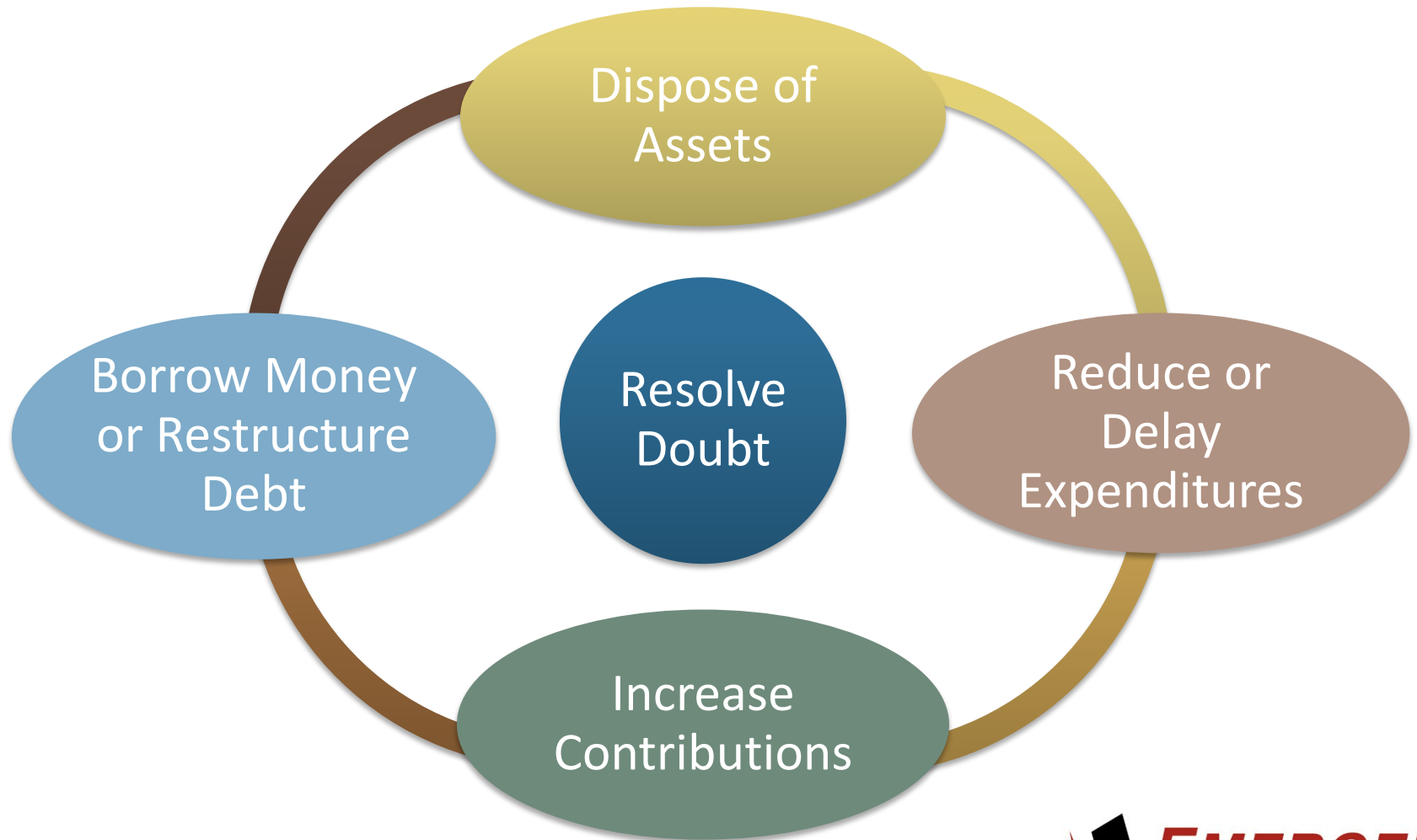
FASB Codification Requirements Going Concern Assessment

- Requires management to assess an entity's ability to continue as a going concern when preparing and presenting F/S:
 - If substantial doubt about ability to continue as a going concern, informative disclosures required under Subtopic 205-40
 - Do not change to liquidation basis of accounting until entity's liquidation becomes imminent, as defined by Subtopic 205-30

Considering Mitigating Effect of Management's Plans In Alleviating Doubt



Possible Mitigating Plans and Intentions



Required Disclosures

1. If substantial doubt is not alleviated, must disclose concerns and management's plans intended to alleviate the substantial doubt
2. If management's plans successfully reduce likelihood of uncertainty, must still disclose initial concern and how substantial doubt was alleviated
3. For first subsequent period where initial substantial doubt no longer even exists, disclose how substantial doubt was resolved

What does a grape say when it is stepped on?

- Nothing, it just lets out a little wine....

Thank you!