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New Financial Statement Considerations for 2020

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***Published December 1, 2020* - In speaking with business owners throughout the year, we have certainly learned of the unprecedented operational changes that have been made due to COVID-19. Similarly, in preparing financial statements, accounting departments will be faced with new questions and challenges that may not have required as much emphasis during "normal" years.**

Here we will examine some of the key considerations that should be made in preparing financial statements this year.

Asset Impairments:

Given the deterioration in certain economic conditions related to the pandemic, financial statement preparers must give careful consideration to potential asset impairments. Some examples include the possible impairment of investments, inventory, indefinite-lived intangible assets, and amortizing and depreciable assets.

While certain investments are recorded using a mark-to-market approach with the gains and losses recognized through net income, others that do not follow this path may be impaired if their market value has decreased substantially during the year. Similarly, equity method investments may also be impaired if the investee has sustained a non-temporary loss in value, perhaps through continued operating losses. The investor entity also needs to consider if certain actions taken will now require the consolidation of an investee. Such investor actions may include additional equity investment, assuming of investee's debt, or restructuring of the investee's ownership or Management.

Inventory operations may have been severely impacted by required business closures, fluctuations in demand, and COVID-19 processing changes. If Management has concerns as to the demand of year-end inventory, a write down may be required from cost to net realizable value (NRV).

As in prior years, both goodwill and indefinite-lived intangible assets (such as tradenames) require impairment testing at least annually, however, several internal and external indicators of impairment may be newly present for 2020. Such external factors include a deterioration in industry economic conditions, detrimental foreign exchange fluctuation, freezing of capital markets, or the adverse impact of regulatory changes and restrictions. Internal factors include steep rises in labor and raw material costs, inadequate cashflow, declines in revenue streams, production disruption, and discontinuations within the Company's strategic plan. Depending on the severity of these factors and the Company's overall response to the pandemic, Management may be required to perform a quantitative analysis to determine if an impairment has occurred.

Both property, plant and equipment, and amortizing intangible assets (such as patents and copyrights) also require impairment testing if certain triggering events have occurred. Potential triggering events may include unsuccessful intellectual property litigation, discontinued product lines, or substantial deterioration of capital asset markets.

Debt & Lease Modifications:

The impacts of COVID-19 may have led a borrower to violate their debt covenant or modify their existing debt arrangement. Depending on the provisions of the debt agreement and the intent of the lender, upon violation of the debt covenant, the debt balances may need to be reclassified as current. More often, the lending parties will proactively renegotiate the loan agreements and covenant terms. In doing so, the borrower must analyze the circumstances within the renegotiated agreement to determine which of three accounting models is most appropriate to account for the change.

Given the abundance of work from home policies, potential production shut-downs, and cashflow concerns, leasing arrangements may have been renegotiated as a result of the pandemic. Particularly, lessees may have received lease concessions from their lessor. To ease the burden of accounting for such concessions, the FASB issued a Q&A (*Topic 842 and Topic 840: Accounting for Lease Concessions Related to the Effects of the COVID-19 Pandemic)* which allows both the lessor and the lessee to potentially avoid lease modification treatment if the concessions granted result in the total lease cash flows being substantially the same or less than the original lease provisions. It is also important to note that while the FASB has extended the adoption date for the new lease standard (ASC 842) for non-public entities to 2022, Management should not underestimate the potential complexity of the implementation effort depending on their lease arrangements.

Revenue Recognition:

Revenue recognition in accordance with ASC 606 may require additional analysis if there are changes in variable consideration, contract terms, or customer collectability. In investigating variable consideration, the financial statement preparer must identify any required changes to the estimates used for product refunds, returns, milestone payments, penalties, and price concessions that may have occurred due to the economic impacts of COVID-19. Additionally, certain alterations within the contract terms may require adjustment and disclosure as either a separate contract, a termination of the original contract and a new contract, or attached to the original contract. Collectability also requires heightened scrutiny in the COVID-19 financial reporting environment. Specifically, if a customer's creditworthiness has deteriorated substantially, Management must reassess both the incoming recognition of revenue and the allowance for doubtful accounts reserve.

COVID-19 Financial Assistance Reporting:

Perhaps the most profound consideration for an entity who accepted COVID-19 assistance through the Small Business Administration's Paycheck Protection Program (PPP) or other programs will come in the reporting of the funds received and the related loan forgiveness. As Nick Fiume points out in his recent blog post, how to account for the COVID-19 assistance provisions is a complex decision that requires consultation of the accounting guidance, tax implications, and overall business strategy. Below is a link to Nick's post which details key considerations for Management's Year-End CARES Act Funding Strategy.

What's Your Year End Strategy for CARES Act Funding? | Dopkins & Co LLP

In summary, there are many unique financial statement topics to consider for 2020 that may require more time and attention than typical years. At Dopkins & Company, our team is ready to help you navigate the standards and the nuances that arise with your business' fact and circumstances. For financial statement preparation assistance or accounting standards guidance, we are just a call or an email away.

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