Coronavirus (COVID-19): Accounting Matters

This is a White Paper on some of the more significant effects of the coronavirus outbreak on financial statements of entities with periods ending December 31, 2019 and earlier. There is a GAAP progression at work here and remember that entities preparing their financials on another comprehensive basis of accounting (OCBOA) must follow GAAP when it comes to disclosures.

For entities that have not yet issued their financial statements for periods ending December 31, 2019 and earlier, the coronavirus is most likely a type II event. For financial statements for periods ending in 2020, it is most likely a type I event. As a refresher, subsequent events fall into two categories:

1. **Type I:** Events occurring after the balance sheet date which provide evidence about conditions that existed at the balance sheet date. GAAP calls for recognizing the effects of type I subsequent events in the period end financial statements. Examples include …
   a. A lawsuit open at year-end that was accounted for as a contingency is settled after year-end. The year-end estimate would be adjusted using the information in the settlement
   b. A lawsuit is filed after year-end for an event which occurred before year-end. An estimate of the loss would be recorded using the information available as of the date the financial statements are issued
   c. An account receivable goes bankrupt after year-end. GAAP calls for estimating whether the events which caused the bankruptcy were present at year-end. If they were, it's a type I event. If not, it's a type II event (see below)
   d. After year-end, inventory is sold at a loss. As with the subsequent loss on accounts receivable, you would estimate whether the condition which caused the loss was present at year-end, and if it was revise the estimate based on the subsequent event

2. **Type II:** Events which are conditions arising after the balance sheet date. GAAP calls for disclosure of the nature of the event and disclosure of an estimate of its financial effect to keep the financial statements from being misleading. Examples include …
   a. A lawsuit filed after year-end for something that happened after year-end
   b. Fires and natural disasters occurring after year-end
   c. A coronavirus epidemic occurring after year-end (a Chris Rouse Accounting Principle)

One suggested disclosure I have frequently seen is along the following lines:

Because of the severity and global nature of the COVID-19 pandemic, it is reasonably possible that the estimate(s) in financial statements will change in the near term and the effect of the change will be material.

WINDHAM BRANNON
offering more

This at least implies, and some might consider it requires, that GAAP calls for recognition of the effects of the coronavirus in financial statements with periods ending before the virus was recognized. That is not correct – it fits the GAAP definition of a subsequent event that is disclosed but not measured in financials for periods ending before the coronavirus outbreak in the U.S. You should be careful to avoid implying in the notes that the 12-31-2019 amounts might be adjusted for the effect of the coronavirus. However, the coronavirus is an "event", and if material that would call for disclosure of a potential write-down in financial statements with periods ending in 2020 for impairments, reserves for receivables, considerations for going concern, and perhaps others.

Now for some suggestions in disclosing the coronavirus outbreak, mostly focused on financials for periods ending December 31, 2019 and earlier.

First, the Nature of Business footnote (NoB) is where entities disclose general information about the entity's business, it's markets, customers and suppliers, and foreign sales and/or suppliers. This would be a good place for preparers to be more considerate of these matters than in prior years, ie power up the information so a reader can discern generally what disruptions the coronavirus outbreak poses for the entity's business. An entity that has substantial physical contact with customers has a different risk than one that is primarily virtual, so include info on that in the NoB note. After getting the NoB powered up, something like the following template can be used to craft the specific disclosure of the virus in the NoB note:

> Subsequent to year-end, a world-wide outbreak of a novel coronavirus disrupted business activity in the U.S. as people, businesses and governments reacted to deal with the health issues posed by the virus. Some industries have been affected more than others by the impact on employees, customers and supply chains, and because the outbreak is ongoing, it is not yet possible to foresee the ultimate outcome of the coronavirus outbreak on the business of the Company. As of the date these financial statements were available to be issued, the Company's operations (describe known effects on employees, customers, suppliers – the more material the more needs to be said)
>
> > eg. Approximately xx% of the Company's revenues are from outside North America, and (whatever is happening)
> > eg, Most of the Company's customers are in the travel business, which has been significantly adversely impacted by the coronavirus. etc
> > eg, approximately xx% of the Company's inventory is obtained from suppliers outside of North America. As of date (describe how supply chain affected). Whether these suppliers will be able to continue supplying the Company is uncertain. If they are unable to do so the Company expects to (describe alternative)

If the impact so far is minimal, something like …

The Company's revenues and sources of supply are from local businesses and suppliers in the whatever industry, and management expects the disruptions in its business to substantially end when the effects of the coronavirus outbreak are substantially relieved.

If the Company is pretty much virtual, something like the following might work… Most client service is done remotely, and most employees can or do work remotely (or whatever is the truth).

Second, many preparers include *Subsequent Events* as an accounting policy. There is no need to say anything about the coronavirus in the Subsequent Events note so long as it is covered elsewhere (eg, in NoB). If you feel compelled, referring in the subsequent events accounting policy to other notes would be ok. Note that for financials with periods ending 12-31-2019 and earlier, the coronavirus outbreak is a type II subsequent event that doesn't require measurement, so there is no effect on the amounts reported in 12/31/2019 financials. If you feel compelled, at the end of the subsequent event accounting policy something like this could be appended;

> U.S. GAAP does not call for recognizing events occurring subsequent to the date of the financial statements when measuring estimates, reserves, write-downs, etc. Accordingly, the potential effects of the coronavirus outbreak on the Company's financial position and results of operations for the year-ended December 31, 2019 do not affect the amounts in these financial statements.

And then there's the Going Concern issue. If there is disruption, that would also call for going concern consideration, which automatically calls for disclosing it was considered and how the entity plans to mitigate the effects of the coronavirus. GAAP does not require the use of the words "going concern" or "substantial doubt". The definition of " substantial doubt about the ability of the entity to continue as a going concern" is "it is probable that the entity will not be able to meet it's obligations as they become due for a period of one year from the date the financial statements are available to be issued". I have seen several public companies that use the latter language and never say "substantial doubt" or "going concern".

Because of the virus, the bad debt accounting policy should include the normal term for collection, which for many entities is less than the March date the effects of the virus began to be seen in businesses in the U.S. If the normal term for collection is more than 90 days, then the possible effect on future collections should be discussed. But there is no GAAP requirement to *measure* the coronavirus in 12/31/2019 bad debt reserves.

Asset impairments might also be impacted by the coronavirus. As noted above, GAAP does not call for impairment to be measured because of a subsequent event, but if an asset is impaired by a subsequent event occurring before the financials are issued then disclosure is required by GAAP (assuming material). The general disclosure above re the ongoing nature of the outbreak provides language for the uncertainty.

Loan covenants might also be impacted by the virus, so if there are loan covenants you should consider disclosure of the virus in that footnote.

Going Concern – When substantial doubt exists at the date the financial statements are issued that if the entity does nothing to deal with the coronavirus it is probable the entity will not be able to meet its obligations as they become due for a period of one year from the date the financials are issued (whew! – take a breath), then something like the following becomes necessary. It does not have to be titled "Going Concern", and it could be in the NoB disclosures as an untitled last paragraph.

> U.S. GAAP requires management to consider whether it is probable that the Company can continue to meet its obligations as they become due. While management believes that based on events and circumstances at year-end it is probable that they would be able to meet obligations as they become due, the subsequent disruption to the business of the Company as a result of the coronavirus outbreak raises uncertainties about the Company's future. Management is currently in the midst of dealing with the immediate impact of the coronavirus on its employees and its business operations. In order to deal with
>
> a. the expected loss or revenues
>
> b. the disruption to the Company's supply chain
>
> c. whatever Management plans to (explain management's response)

GAAP will set you free! Use it!!

Auditor's Reports:

Except in situations where the entity is virtually certain to tank, there is no requirement to put an emphasis paragraph in the auditor's report. See Sears 12/31/16 10k when they had a Going Concern note and the audit report was silent on it. However, it is certainly ok to have an emphasis paragraph.

This White Paper has focused on 12/31/2019 and earlier financial statements because that is the immediate concern. Look forward to another White Paper covering financials periods ending in 2020. In the meantime, …

Chris Rouse

Audit Director, Windham Brannon, LLC

Crouse@windhambrannon.com