

Financial Reporting Pressures and the COVID-19 Crisis

Considerations for the Quarter Ending March 31, 2020

Part One: Presenting Accounting Estimates

As public registrants prepare their financial reports for the first quarter of 2020, they will be dealing with unique reporting judgments due to the economic impact of COVID-19 and recent government actions. Many of the financial reporting judgments will be especially difficult because of so many unique unknowns such as the duration of the crisis, whether vendors will be able to deliver on commitments, possible accounts receivable collection problems, and other matters that each registrant may be encountering.

To help our clients understand and assess the financial reporting matters under consideration, we will be presenting a multi-part series over the next few weeks dealing with several of these topics, starting with today's discussion regarding presenting accounting estimates.

Financial reporting involves forming numerous judgments, estimates, and assumptions. Common examples include revenue recognition, collectability of receivables, impairment of assets, contingent liabilities, certain accruals, and contingencies. Of significance, this is exactly why financial statements are referred to as "free from material misstatement," as many reported amounts are management's predictive values, often based on limitations in knowledge or data. The complexity, subjectivity, and uncertainties inherent in the measurement of these financial statement amounts affects their susceptibility to misstatement.

Add to the ordinary processes, the uncertainty of the COVID-19 crisis, and public registrants will have very unique circumstances to deal with for the quarter ending March 31, 2020.

Company-Wide Impact Memo

Our advice to our clients and those involved in the financial reporting process is to prepare a company-wide memo describing the macro and micro impacts of the current crisis on their business. The memo should include relevant facts and management's judgments regarding the impact of the crisis on the company's vendors, customers, workforce, cash flow, and liquidity, as well as the estimated duration for the crisis, both near term and an assumed recovery period to normalcy. These latter factors will be essential to a company's financial models involving assumptions underlying many financial reporting estimates. Importantly, the memo should document management's strategy by segment or division, and their approach to work through the current situation, which may involve different scenarios as well as cash flow models. This memo will be foundational to all accounting estimate determinations, although each estimate will require individual considerations.

Estimating the Crisis Duration

As mentioned above, we recommend a two-step process to estimate the duration due to the severity of the current business as usual stoppage, then address the period of time for operations to achieve normalcy. Assessing each period will involve a significant amount of judgment. Needless to say, assumptions about conditions existing as of March 31, 2020, will need to be updated for subsequent events through the filing date for the registrant's financial statements.

As to the near term, Dr. Anthony Fauci, Director of the National Institute of Allergy and Infectious Diseases recently said disruptions in everyday life in the United States could last up to eight weeks. When modeling the impact on accounting estimates, this two-month period could be conservatively projected to apply to the entirety of the third quarter of 2020. Importantly, this crisis period will involve immediate balance sheet impacts as well as productivity impacts, which may carry forward into cash flow considerations for the following quarter or quarters.

Next, for modeling, it will be necessary to form assumptions regarding the period of recovery to return to normal operations. This will be different for all companies, and unfortunately some may even realize permanent impairments. Depending on the depth of a recession, for some, this period may be longer. At a minimum, it would appear reasonable to consider a minimum of three months to restore normalcy.

Specific Estimate Calculations and Memos

Using the company-wide memo, including the assumptions regarding the duration of the crisis and recovery for the business, the next step is to analyze each accounting estimate. Of note, registrants should describe the estimate starting with how it's been prepared in the past, the new facts and events, and the updated assumptions that will be employed in the current period calculations. This will be very important audit evidence and registrants should confer with both their internal and external auditors regarding expectations for documentation in advance.

In closing, subsequent parts for our series includes:

- Part Two – Measuring and Reporting on Liquidity
- Part Three – Defining Risks in a Balanced Manner
- Part Four – Testing for Goodwill Impairments
- Part Five – Disclosure Considerations

We hope this discussion is informative and offers practical advice on an approach to deal with this unique circumstance arising from the current crisis. If you have questions or suggestions, please let us know. Thank you.