In depth

No. US2020-02
March 19, 2020
(updated January 14, 2021)

FAQ on accounting for COVID-19 and market volatility

What's inside

At a glance

Almost all companies have been impacted by COVID-19 and the related volatility in financial markets and changes in the economic environment. The extent of the impact may be both direct and indirect and will vary based on a variety of facts and circumstances, including a company's industry, location, customer and supplier diversification, and the duration of the pandemic.

This *In depth* answers specific questions about a range of accounting topics that may be impacted by the pandemic and the economic environment. It was originally issued in March 2020 and updated several times in the following months.In this refreshed version, we have reorganized the document to better support research by reordering the FAQs and grouping all FAQs on the same topic. Although renumbered, substantive changes were not made to the content unless a question is specifically noted as being updated in January 2021. Certain questions that are no longer applicable have been deleted.

We have also added additional questions related to the accounting for lease concessions and the impairment of right-of-use assets.

Also see our FAQ on the CARES Act, which has been updated for the December additional stimulus package.

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Compensation

QUESTION 1.1

Can a company spread the effects of increased (or in some cases, reduced) costs or accruals associated with employee compensation and benefits over the entire year or must they be recognized in the period in which the change occurs?

PwC response

A company may have a variety of employee compensation and benefit programs that could be affected by the current circumstances. For example, expectations of performance bonus payouts may be negatively affected by reduced forecasts; or a company that has self-insured medical or disability plans for employees may find that its liability for incurred but not reported (IBNR) claims has increased as employees and their families contract illnesses associated with the coronavirus.

Accounting guidance for compensation and benefits for active employees generally requires an updated assessment of the estimated cost of those arrangements at each reporting period. For example, benefits provided under pre-existing plans to employees while they are inactive or no longer employed (but prior to retirement), such as disability or severance (see Question 1.4), are subject to ASC 712, *Compensation - Nonretirement Postemployment Benefits*. Cash bonus plans are subject to ASC 710, *Compensation - General*. While neither of these standards provide extensive guidance on measurement beyond termination benefits and certain compensated absences, they generally are based on recording amounts that are probable and estimable, consistent with the guidance in ASC 450, *Contingencies*. Such amounts are considered accounting estimates. Consistent with the guidance in ASC 250, *Accounting Changes and Error Corrections*, changes in accounting estimate should be accounted for in the period of change (or in the period of change and future periods if the change affects both, such as estimates of depreciable lives).

For example, when the performance condition associated with a cash bonus plan is not considered probable, no cost is accrued, or previously accrued cost is reversed. If a performance condition is initially considered probable and the assessment of the probability changes, we generally believe it is appropriate to adjust the accrual to reflect the amount that cumulatively would have been accrued by the end of the reporting period based on the updated assessment, although other approaches may be acceptable depending on the facts and circumstances.

While not explicitly addressed in the authoritative literature, we believe that the cost of providing other fringe benefits (such as medical benefits) to active employees should be recognized as the costs are incurred. If the company pays solely for third-party insurance and has no responsibility to pay for actual costs incurred (including through retrospective pricing), the cost of the insurance premiums represents the company's cost. However, if the company is ultimately responsible for some or all of the actual medical costs incurred, it should record an accrual for incurred costs (claims) and expected future claims

(IBNR). IBNR is an accounting estimate, which should be updated each period as those amounts change.

ASC 270, *Interim Reporting*, provides a framework for spreading some costs across interim periods, notwithstanding the timing of when a liability should be accrued, if the cost specifically benefits more than one interim period (such as annual insurance premiums or property taxes, as well as annual bonuses). However, costs and expenses incurred in one interim period that cannot be readily identified with the activities or benefits of other interim periods should be recorded when incurred. Additionally, ASC 270-10-45-14 requires that the effect of a change in accounting estimate be accounted for in the period in which the change in estimate is made. Therefore, we would generally expect changes in the accounting estimates inherent in the employee benefit programs described above to be recognized in the period those estimates change.

QUESTION 1.2

What is the appropriate accounting treatment if a company continues to pay employees or provide medical or other benefits while they are not working?

PwC response

It depends. The accounting guidance for payments to employees is varied and, at times, inconsistent depending on the nature of the payments and the way in which they are communicated to employees. Certain types of payments are accrued either as service is provided or when the events giving rise to the payments become probable and the amounts are estimable. For example, if a company has a pre-existing plan to continue to provide medical benefits to furloughed employees, that arrangement would be subject to ASC 712, *Compensation - Nonretirement postemployment benefits*, and the amounts should be accrued when a furlough is probable and the amounts can be reasonably estimated. Similarly, severance benefits paid for permanent termination of employment under a pre-existing plan that varies based upon years of service should be accrued when payment of the severance amounts are probable and estimable. Other types of one-time benefits may be accrued when defined criteria are met, or may be accrued over time as the employees render service. For example, special termination benefits offered for an employee's voluntary termination of service should be recognized when the employee irrevocably accepts the offer. One-time involuntary termination benefits would not be recognized until the criteria in ASC 420, *Exit or Disposal Cost Obligations*, are met, and may be recognized over time if continued service is required to earn the benefit. Sick leave benefits are typically recorded as incurred (i.e., when employees take sick days) under ASC 710-10-25-7.

A number of companies have decided to close facilities and furlough employees during the COVID-19 outbreak but continue to pay those employees for a period of time. Management should carefully evaluate the arrangements to determine whether one of the accounting models described above specifically applies to those payments.

For payments to employees that are not clearly addressed by the existing accounting models, judgment will be required. For example, the definition of "inactive employees" in ASC 712 includes employees who have been laid off but who have not been terminated. A company's discretionary decision to continue to pay salaries to furloughed employees might be similar to continuation of compensation and benefits under ASC 712. However, because the employees' rights to that compensation do not vest or accumulate based on past service, they would be accrued when they are probable and estimable, in accordance with ASC 450, *Contingencies*. Under this approach, the communication of the company's intention to continue to pay salaries for a period of time while employees are furloughed could lead to a determination that the payment of such amounts are probable. There may be significant judgment in the determination of what amounts are reasonably estimable (e.g., how long the furlough is likely to last and how long the company will pay employees).

Another view is that ASC 712 only applies to a mutually understood arrangement (either through a written plan or through a consistent past practice that would constitute a "substantive plan"). For most companies, the continued payment of salaries to furloughed employees is a discretionary one-time action, in which case it would not represent a mutually understood "plan." This would be consistent with the conclusions reached by the EITF in Issue 01-10, "*Accounting for the impact of the terrorist attacks of September 11, 2001*." In that guidance, payments of salaries to employees who were unable to work due to government-imposed restrictions on access to facilities were expensed as incurred, unless the criteria for accrual in ASC 710-10-25-1 for compensated absences was met. In most cases, these criteria would not be met, as the right to these payments did not vest or accumulate based on past service. Therefore, the payments to furloughed employees would be expensed as incurred.

If accrual is considered, management also needs to assess whether the payments to employees provide any current benefit to the company, as ASC 710-10-25-4 prohibits the accrual of future costs that will provide a benefit to the employer as they are incurred. In this context, while employees are not directly providing services during the furlough period, the payments may be designed to keep the company's active workforce available when the company is able to re-commence operations. In that case, recognizing the cost of the employee compensation as paid, rather than accruing an estimate of the total furlough pay at the inception of the furlough period, may be appropriate. In addition, as the payments are discretionary and may be stopped at any time, they may not meet the definition of a liability in FASB Concepts Statement 6, *Elements of Financial Statements*.

Based on the above considerations, we generally believe that arrangements that are not covered by a "substantive plan" and do not vest or accumulate based on past service would be expensed as incurred.

However, judgment is required based on the facts and circumstances, including the following:

- what information and commitments have been communicated to employees and what obligations that imposes upon the company,
- any governmental or statutory requirements on continuation of pay and benefits, particularly in international jurisdictions,
- the nature of employees' requirements in order to continue to receive the payments,

- what benefits the company may obtain from maintaining its current workforce through ongoing payments,
- how clear the timetable is for continued payment or return to some other work arrangement,
- whether the layoffs are considered temporary or permanent, and
- any past practice or written benefit programs made available to employees.

This assessment would be appropriate for any type of continued payments to furloughed employees including, for example, salary, payroll taxes, medical benefits, other fringe benefit costs, vacation accruals, and stock-based compensation. Management should also consider whether employees continue to earn credit (i.e., years of service) for these benefits during the furlough.

QUESTION 1.3

What is the appropriate accounting treatment if a company either reduces or eliminates salary for a period of time, or furloughs employees without pay or benefits for a period of time?

PwC response

Some companies may furlough employees without pay or benefits for a period of time. Other companies may decide to reduce (or even eliminate) salaries of certain individuals for a period of time, even if they continue to provide services to the company. In each of these cases, employees will receive a reduced overall amount of annual pay during the current year.

While there is no specific authoritative literature on wages and salaries paid to an employee during employment, companies should recognize these costs as services are provided and salaries are earned. FASB Concepts Statement 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, sets out the principle that the consumption of an entity's economic resources to support its ongoing operations should be recognized as an expense. Further, specified changes in salary levels over the course of an employment contract are not averaged together and recognized on a level basis over the term of the contract, because employees can voluntarily terminate at any time and therefore the arrangements are executory. In the case of furloughing employees without pay, the absence of pay corresponds with the lack of direct service to the company (although there may be other forms of economic benefit received, as discussed in Question 1.2). Even in the case of reduced or eliminated salaries, employees are earning less for their service during the current period (assuming there is no explicit or implicit agreement to reimburse the employees for the reduced salaries at a future date).

We believe companies should recognize wages as services are provided and salaries are earned, rather than spreading the revised annual salary over the remainder of the fiscal year. ASC 270-10-45-8 to ASC 270-10-45-9 states that if a specific cost that is charged to expense for annual reporting purposes benefits more than one interim period, the cost may be allocated across those interim periods. However, it goes on to note that some costs incurred in one interim period cannot be readily identified with the activities or benefits of other interim periods and should be charged to the interim period in which they are incurred. While the situations discussed in this question result in the employees' annual salary being reduced, the costs that may be paid in later quarters (assuming the individuals remain employed and receive a higher future salary) cannot be readily identified with the activities of the current quarter. Therefore, we believe the wages should be recognized as they are incurred and earned each quarter.

QUESTION 1.4

When should companies record a liability related to termination benefits provided as a result of COVID-19?

PwC response

The guidance for recording liabilities associated with terminations varies depending upon the nature of the benefits, specifically, if they are associated with a voluntary or involuntary termination, and whether the arrangements through which the benefits are paid have previously been made known to employees.

Voluntary or "special" termination benefits arise when the employer offers, for a short period of time, certain additional benefits to employees electing voluntary termination. A liability should be recorded and an expense recognized in the period the employees irrevocably accept the offer and the amount of the termination liability is reasonably estimable. That timing would generally coincide with when the employees irrevocably accept the offer as it would be unlikely that the termination liability would not be reasonably estimable at that time. It would not be appropriate to record an accrual at the time of the offer based on an estimated acceptance rate, nor would it be appropriate to record acceptances that occur after the balance sheet date as a recognized subsequent event.

Benefits provided for involuntary terminations in accordance with a mutually understood arrangement (either through a written plan or through a consistent past practice that would constitute a "substantive plan") are accounted for in accordance with ASC 712, *Compensation—Nonretirement Postemployment Benefits*. These benefits include salary continuation, supplemental unemployment benefits, severance benefits, disability-related benefits (including workers' compensation), job training and counseling, and continuation of benefits, such as health care benefits and life insurance coverage. They should be recognized when it is probable the event will occur and the amount can be reasonably estimated. This will often coincide with the establishment of a plan to terminate employees, although judgment is necessary in assessing when the payment of benefits is considered probable. Uncertainty regarding the timing of benefit payments does not preclude the recognition of the obligation. Because these benefits are associated with past service under the previously understood arrangement, they should be immediately recognized, even if there is a requirement to work through a particular future date to receive them.

One-time involuntary termination benefits that are not provided under either the terms of an ongoing benefit arrangement or enhancements to an ongoing benefit arrangement that would not be applicable for future events are recognized when all of the conditions specified in ASC 420-10-25-4 are met.

Excerpt from ASC 420-10-25-4

An arrangement for one-time employee termination benefits exists at the date the plan of termination meets all of the following criteria and has been communicated to employees (referred to as the communication date):

a. Management, having the authority to approve the action, commits to a plan of termination.

b. The plan identifies the number of employees to be terminated, their job classifications or functions and their locations, and the expected completion date.

c. The plan establishes the terms of the benefit arrangement, including the benefits that employee's will receive upon termination (including but not limited to cash payments), in sufficient detail to enable employees to determine the type and amount of benefits they will receive if they are involuntarily terminated.

d. Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

Expense is recognized immediately if future services are not required in order for employees to receive the termination benefits, or ratably over the period of required future service if they are.

Additional resources:

- PwC's *Pensions and employee benefits* guide, Chapters 6 and 8
- PwC's *COVID-19: Restructuring questions, answered* podcast

Stock-based compensation

QUESTION 1.5 (updated January 2021)

What is the impact if a company modifies performance targets of stock compensation awards to "rebalance" the targets in light of the impact of COVID-19 on the business, or allow grantees to earn awards that would not otherwise be earned based on actual results?

PwC response

In these situations, it is important to first remember the distinction between performance conditions, which would typically be company-specific targets, such as revenue or earnings, and market conditions, such as achieving a target stock price or total shareholder return. While both affect whether an employee actually earns an award, performance conditions affect how much (if any) compensation cost is recorded whereas market conditions only affect the grant date fair value of an award.

Performance conditions
If a company changes the performance targets (such as revenue or earnings) required to earn a stock compensation award, this would be considered a modification of the award. On the modification date of an equity-classified award, management should assess the probability of both the original and modified vesting conditions being satisfied.

If the award was probable of vesting before the modification and probable of vesting after the modification, the cumulative amount of compensation cost that should be recognized over the requisite service period of the award is the original grant-date fair value of the award plus any incremental fair value resulting from the modification itself. For example, if the new performance targets will result in a higher number of awards that are probable of vesting than under the original terms, the fair value of those additional shares at the modification date would be considered the incremental fair value arising from the modification.

If the award was not probable of vesting before the modification, but the performance conditions are changed such that it is now probable of vesting after the modification, the cumulative compensation cost recognized for the original award would be zero immediately prior to the modification (as none of the awards were expected to vest). The "incremental" fair value is therefore equal to the fair value of the modified award on that date. This incremental compensation cost would be recognized over the remaining requisite service period, if any. This is considered a "Type III" (improbable-to-probable) modification under ASC 718-20-55-116 to ASC 718-20-55-117. In this situation, the amount of total compensation cost could be more or less than the original award's grant-date fair value.

Market conditions
Equity-classified awards with market conditions (such as a target stock price or total shareholder return) are measured and accounted for differently than awards with performance or service conditions. At the grant date, the effect of the market condition is reflected in the fair value of the award and the recognition of compensation cost is solely dependent upon the recipient completing the requisite service, regardless of whether the condition is actually achieved. If the grantee is expected to complete the requisite service at the time of the modification, a company would recognize compensation cost equal to the unrecognized grant-date fair value of the original award plus any incremental fair value of the modified award over the remaining requisite service period.

Liability-classified awards
The general principle of exchanging the original award for a new award also applies to a modification of a liability-classified award. Unlike an equity-classified award, however, a liability-classified award is remeasured at fair value at the end of each reporting period. Therefore, a company would simply recognize the fair value of the modified award by using the modified terms at the modification date. There is no "floor" or requirement to recognize at least as much as the grant-date fair value of a liability-classified award as the ultimate compensation expense will equal the fair value on the settlement date.

All awards
Modifications of stock compensation awards can only be reflected in the period that the modification actually occurs. Future modifications cannot be anticipated at the balance sheet date, and those that occur after the balance sheet but

before the issuance of the financial statements are nonrecognized subsequent events. The accounting at the balance sheet date must reflect the terms as they existed at that date.

QUESTION 1.6

What is the impact if a company grants new performance-based stock compensation awards but wishes to delay setting the performance targets until there is greater clarity on the impact of COVID-19 on the company's business and forecasts?

PwC response

If a company issues a new share-based award that vests upon achieving a performance target, but delays setting the performance targets, management needs to consider whether a grant date has been established. A grant date is established and compensation cost becomes fixed based on the grant-date fair value of an equity-classified award when all of the following criteria are met:

- The company and the grantees have reached a mutual understanding of the award's key terms and conditions.
- The company is contingently obligated to issue shares or transfer assets to grantees who fulfill vesting conditions.
- The grantees begin to benefit from, or be adversely affected by, subsequent changes in the company's stock price (e.g., the exercise price for an option is known).
- Awards are approved by the board of directors, management, or both if such approvals are required, unless approval by one or more parties is considered perfunctory.
- The recipient is an employee (i.e., grant date cannot be established prior to the first day of employment) if the award is for employee service.

One of the key terms of an award is the vesting criteria: what the recipient must do in order to earn the award. For an award with a performance condition, the performance condition is part of the vesting criteria. If the performance target has not yet been defined and communicated, then a mutual understanding of the key terms and conditions of the award would not exist (ASC 718-10-55-95).

To establish a grant date, performance targets should be objectively determinable and measurable. However, this determination might not always be straightforward. For example, the company might issue an award with an initial performance target, but the compensation committee has the ability to adjust, at its discretion, the target itself or how performance against the target will be measured. When assessing whether the discretion by the compensation committee (or others with authority over the compensation arrangement) to make adjustments to performance targets related to COVID-19 (or otherwise) impacts the timing of when a grant date has been achieved, a company should consider whether there are objective criteria for making adjustments to an award and whether the holders of the award have an understanding of when and how the terms of the award will be adjusted. As the impacts of COVID-19 likely remain subject to significant uncertainty, companies may find it challenging to assert that award holders would have a clear understanding of when and how the terms of the award will be adjusted.

If the company determines that a grant date has not been established, then it should also consider whether there is a "service inception date" prior to grant date. This is discussed in ASC 718-10-55-108. One of the key considerations in these circumstances would likely be whether the award's terms include a substantive future requisite service condition that exists at the grant date (ASC 718-10-55-108(c)1). If the award will be fully vested by the time the performance condition is established, then it is likely that the service inception date precedes the grant date. In that case, a company should recognize compensation cost over the requisite service period beginning on the service inception date, and should remeasure the fair value of the award each period until the grant date.

If the service inception date does not precede the grant date, then no accounting is required (or appropriate) for the award until the grant date. No compensation cost would be recognized until that time, and the fair value of the award on the ultimate grant date would be recognized prospectively over the service period.

QUESTION 1.7

Can a company exclude recent stock price activity during parts of 2020 when incorporating historical volatility into the determination of the expected volatility assumption needed to value stock options?

PwC response

One of the inputs into determining the fair value of a stock option or related share-based payment award is the expected volatility of the company's stock price over the expected term of the option. All other things being equal, a higher volatility of the stock price results in a higher fair value of the award.

Volatility may be derived from historical stock price movements over time, implied from the market price of traded options or convertible securities (if the company has any), or inferred from the volatility of similar (peer) companies for non-public companies or those that have not been public for a long enough period of time to accumulate sufficient historical stock price activity. While typically a company would start with historical information, a company should also consider, based on available information, how the expected volatility of its share price may differ from historical volatility to estimate how a marketplace participant would value the award.

ASC 718-10-55-37(a) observes that in certain circumstances, an entity might disregard an identifiable period of time in which its share price was extraordinarily volatile because of a failed takeover bid if a similar event is not expected to recur during the expected term of the award. However, in order to exclude the historical data from the volatility calculations, such events should be specific to the company, under management's control, and not expected to recur during the expected term of the award. In SEC Staff Accounting Bulletin Topic 14, the SEC staff indicates that such exclusions are expected to be rare.

Based on the narrow company-specific example in ASC 718 and the guidance in the SAB Topic, we believe that volatility data that reflects the broader market should not be excluded from a company's estimate of volatility.

QUESTION 1.8

Can a company use an average stock price over a period of time to measure the fair value of a stock compensation award?

PwC response

No. ASC 718 requires the measurement of share-based awards to be based on their fair value on the measurement date. This applies to newly granted equity-classified awards, which would be measured at their grant-date fair value, as well as to new or existing liability-classified awards that are required to be remeasured to fair value at each period-end reporting date. The fair value of an award is measured based on the fair value of the underlying stock and any other relevant assumptions based on the nature of the award as of the applicable measurement date. Thus, using an average stock price over some other period would not be consistent with the measurement objective.

Additional resources:

- PwC's *Stock-based compensation* guide, Chapters 2, 4, and 9
- *SAB Topic 14* D.1 Question #2(5)
- PwC's *A refresh on stock comp basics before you modify your stock options* podcast

Debt

QUESTION 2.1

What should a company consider if it expects a debt covenant violation on or after the balance sheet date?

PwC response

Debt is classified as current if the debt is puttable at the balance sheet date due to the covenant violation. If a lender waives its right to put the debt based on that particular covenant violation for at least one year from the balance sheet date, the debt will not automatically be classified as noncurrent. A company that has to meet the same or more restrictive covenant going forward must determine if it is probable that it will fail those covenants within one year from the balance sheet date. If it is probable, the debt must be classified as current despite the waiver.

The same assessment must be done if debt is modified to avoid a covenant violation at the balance sheet date.

If a violation happened after the balance sheet date or is anticipated in the future, the debt would generally be classified as noncurrent, but transparent disclosure of the violation or potential violation is required.

QUESTION 2.2

What should a company consider if it restructures its debt during an economic downturn?

PwC response

Anytime debt is restructured with the same lender, a company should first consider if it has a troubled debt restructuring. This is important because in some cases, the accounting for a troubled debt restructuring can be significantly different from the accounting for a non-troubled debt restructuring. In order for a debt restructuring to be considered troubled, a company must be experiencing financial difficulties and the lender must grant a concession. ASC 470-60 provides indicators to determine if a company is experiencing financial difficulties and guidance on how to determine if a concession was granted. If the transaction is not considered troubled, a company should consider whether the restructuring is a modification or extinguishment based on the guidance in ASC 470-50 (see Question 2.3).

See our *In depth* on the CARES Act for information on the relief afforded financial institutions for loan modifications related to COVID-19 that would otherwise be considered a troubled debt restructuring.

QUESTION 2.3

How does a company determine if a non-troubled term debt restructuring is a modification or extinguishment?

PwC response

During uncertain economic times, a company may need to restructure its debt to extend the maturity date, change the timing of payments, change covenants, etc. Often, the lender will charge a fee or increase the interest rate in order to be compensated for these changes. While a company may be experiencing financial difficulties, the additional fee or interest may lead to a conclusion that no concession was granted, so the transaction is not considered troubled. Therefore it needs to assess the transaction to determine if it is a modification or extinguishment based on the guidance in ASC 470-50.

In order to do this assessment, a company must determine if the new terms of the arrangement have substantially changed from the original debt. This analysis requires a present value calculation to determine if the change in contractual cash flow between the original debt and the restructured debt is greater than 10%. This assessment has some particular nuances that can often be overlooked. These nuances are covered in detail in the podcast and video included in the additional resources below.

If the change in cash flows is greater than 10%, the restructuring is accounted for as an extinguishment; otherwise, it is a modification. The difference between the two outcomes is summarized as follows:

Type of transaction	Debt	New lender fees	New third-party fees
Extinguishment	A gain or loss is recorded for the difference between the net carrying value of the original debt and the fair value of the restructured debt.	Expense	Capitalize
Modification	No gain or loss is recorded. A new effective interest rate is established based on the carrying value of the debt and the restructured cash flows.	Capitalize	Expense

QUESTION 2.4

What is the impact of liquidity risks, including a going concern paragraph, on debt classification?

PwC response

Debt agreements may contain a subjective acceleration clause (SAC) in which the lender can accelerate repayment if the borrower experiences an adverse change. These covenants are typically referred to as material adverse change (MAC) or material adverse effect (MAE) clauses. The likelihood of payment being accelerated impacts the classification of debt with a SAC. If acceleration of the due date is probable based on facts and circumstances at the balance sheet date, debt subject to a SAC should be classified as current. The accounting guidance indicates that liquidity issues and recurring losses are examples of instances that may make acceleration of debt probable.

An audit report with an additional paragraph related to liquidity risks and uncertainties may indicate it is probable that the SAC will be exercised. Although the audit report is issued after the balance sheet date, the liquidity issues resulting in the additional paragraph may have existed at the balance sheet date. Even with no additional paragraph in the audit report, management's disclosure of liquidity issues may also indicate it is probable that the SAC will be exercised.

Additional resources:

- PwC's *Financing transactions* guide, Chapter 3
- PwC's *Accounting for debt in uncertain times: 5 things to know* podcast
- PwC's podcast: Borrower's accounting for debt restructurings: 5 things to know
- PwC's video: Key steps in the debt restructuring model

Derivatives and hedging

QUESTION 3.1

Companies that have designated forecasted transactions in cash flow hedging relationships,such as inventory purchases, sales or revenues, debt issuances, or interest payments, may have decreased their forecasts of transaction volume. How may the change in the probability of a hedged forecasted transaction impact the financial statements?

PwC response

If at any time the likelihood of the hedged forecasted transaction ceases to be probable of occurring, hedge accounting will cease prospectively and all future changes in the fair value of the derivative will be recognized directly in earnings. Any derivative gains or losses deferred in accumulated other comprehensive income (AOCI) prior to the change in likelihood will remain in AOCI until the forecasted transaction impacts earnings (or until the forecasted transaction becomes probable of not occurring). If a company determines that the hedged forecasted transaction is probable of not occurring by the end of the originally specified time period (or within an additional two month window thereafter), amounts deferred in AOCI are required to be recognized in earnings immediately. Additionally, companies are required to disclose the amount of gains and losses reclassified from AOCI into earnings as a result of the discontinuance of hedge accounting.

QUESTION 3.2

What is the potential impact of the current economic environment on a company's ability to continue designated hedges or to establish new hedges?

PwC response

To qualify for hedge accounting, the relationship between a hedging instrument and a hedged item, both at inception and on an ongoing basis, must be highly effective in achieving offsetting changes in fair value or cash flows. Volatility in markets caused by current events may cause a company's existing hedges to no longer be effective, resulting in the need to discontinue hedge accounting, and may also make it difficult to assert that new hedges will be effective.

QUESTION 3.3

How may changes to the supply chain or changes in sales forecasts impact the ability for purchases and sales contracts to qualify for the normal purchases and normal sales scope exception?

PwC response

Companies with derivative contracts that qualify for the normal purchases and normal sales (NPNS) derivative scope exception should consider the impact of lower sales or purchase volumes on the assertion that physical delivery is probable. Under the NPNS exception, a company must conclude that it is probable—at inception and throughout the term of the contract—that physical delivery will occur.

If a reporting entity determines that it is no longer probable that a contract will result in physical delivery, it may need to discontinue its application of the NPNS exception. Whether and when a reporting entity should discontinue application of the normal purchases and normal sales scope exception partially depends on the form of net settlement applicable to the contract.

Method of net settlement	Timing of changes in designation
Net settlement under contract terms (ASC 815-10-15-99a) Net settlement through a market mechanism (ASC 815-10-15-99b)	The normal purchases and normal sales scope exception will cease to apply when physical delivery is no longer probable; this could occur prior to the actual net settlement.
Net settlement by delivery of asset that is readily convertible to cash (ASC 815-10-15-99c)	The normal purchases and normal sales scope exception will continue to apply until the contract is financially settled, even if management intends or otherwise knows that physical delivery is no longer probable.

If a reporting entity determines that one contract no longer qualifies for the normal purchases and normal sales scope exception, this may call into question its ability to assert probable physical delivery for other similar contracts or contracts within a group.

QUESTION 3.4

In rare cases, the existence of extenuating circumstances that are related to the nature of the forecasted transaction and outside the control or influence of a company may cause the forecasted transaction designated in a cash flow hedge to be probable of occurring at a date that is beyond the originally specified period of time, plus an additional two-month period thereafter. In those cases, amounts deferred in AOCI should remain in AOCI until the forecasted transaction affects earnings. That is, in those rare cases, a company should disregard the timing restrictions otherwise applicable to the forecasted transaction and continue to defer amounts previously recorded in AOCI until the forecasted transaction affects earnings.

Would delays in the timing of a forecasted transaction due to the impact of COVID-19 be considered one of those rare cases caused by extenuating circumstances outside of the control or influence of a company?

PwC response

Yes. We believe the extenuating circumstances exception, described in ASC 815-30-40-4, may be applied to delays in the timing of a forecasted transaction when such delays are related to COVID-19, which will require judgment based on facts and circumstances. The FASB staff issued a Q&A document on the effects on the pandemic on cash flow hedge accounting expressing this view on April 28, 2020.The FASB staff expressed a similar view in Question 1 of its FASB staff Q&A.

ASC 815-30-40-4 states that “the existence of extenuating circumstances that are related to the nature of the forecasted transaction and are outside the control or influence of the reporting entity may cause the forecasted transaction to be probable of occurring on a date that is beyond the additional two-month period of time, in which case the net derivative instrument gain or loss related to the discontinued cash flow hedge shall continue to be reported in accumulated other comprehensive income until it is reclassified into earnings pursuant to paragraphs 815-30-35-38 through 35-41.”

Consequently, if the forecasted transaction is probable of occurring at a date beyond the originally specified time period plus the additional two-month period of time, a company may continue to defer amounts previously recorded in AOCI associated with that forecasted transaction until that forecasted transaction affects earnings. However, that exception only applies to situations when the forecasted transaction remains probable of occurring at a date that is beyond the additional two-month period of time. If a company determines that the forecasted transaction ceases to be probable of occurring at a date that is beyond the additional two-month period (for example, lost revenues or cancelled purchases), amounts previously recorded in AOCI should be reclassified into earnings immediately and disclosed in the entity’s interim and annual financial statements.

QUESTION 3.5

A company may determine that cash flow hedge accounting must be discontinued and net derivative gains or losses deferred in AOCI must be reclassified into earnings immediately. This would be the case when (1) the forecasted transaction is probable of not occurring by the end of the originally specified time period or within a two-month period of time thereafter, or (2) the forecasted transaction ceases to be probable of occurring at a date that is beyond the additional two-month period of time when applying the exception for delays in timing due to rare and extenuating circumstances (see Question 3.4). Under ASC 815-30-40-5, a pattern of determining that forecasted transactions are probable of not occurring would call into question an entity's ability to accurately predict forecasted transactions and the propriety of using cash flow hedge accounting in the future for similar transactions.

If a company determines that amounts deferred in AOCI must be reclassified into earnings immediately because of a missed forecast due to COVID-19, should those missed forecasts be considered when determining whether the entity has exhibited a pattern of missing forecasts that would call into question its ability to accurately predict forecasted transactions and the propriety of using cash flow hedge accounting in the future for similar transactions?

PwC response

No. We do not believe that a company would need to consider missed forecasts attributable to COVID-19 when determining whether it has exhibited a pattern of missing forecasts that would call into question its ability to accurately predict forecasted transactions and the propriety of using cash flow hedge accounting in the future for similar transactions as discussed in ASC 815-30-40-5. The determination as to whether the missed forecast is attributable to COVID-19 will require judgment based on facts and circumstances. The FASB staff expressed a similar view in a Question 2 of its FASB staff Q&A.

Additional resources:

- PwC's *Derivatives and hedging* guide

Earnings per share

QUESTION 4.1

How should a company reflect a change in its assertion regarding whether it will settle certain financial instruments in cash or shares in the computation of earnings per share (EPS)?

PwC response

Certain debt instruments and other financial instruments may allow the issuer, at its election, to settle the instrument in cash or shares. Under ASC

260-10-45-45 through ASC 260-10-45-46, when the company has the choice of settlement method for the instrument, it should presume share settlement for EPS purposes. However, that presumption may be overcome, and the company may assume cash settlement, when there is a past practice or substantive stated policy that provides a reasonable basis to believe that the instrument will be settled partially or wholly in cash.

In order to overcome the presumption of share settlement, a company must consider, among other things, its intent and ability to settle in cash. In light of the current economic circumstances, companies should re-evaluate this intent and ability. If a company determines that it must change its previous assertion of cash settlement to the default presumption of share settlement, the computation of diluted EPS should reflect this change prospectively, and the change should be disclosed. In treating the change prospectively, the company should identify the date on which the assertion of cash settlement changed. The computation of diluted EPS would reflect the contract as cash settled up until the date the assessment changed. Thereafter, EPS would reflect the contract as share settled. Each would be weighted for the appropriate number of days in the period. Along with the impact on the EPS denominator, there are corresponding adjustments to the numerator, which are described in ASC 260-10-55-32 through ASC 260-10-55-36A.

The ability to overcome the presumption of share settlement will be more difficult if a company has a past practice of changing its assumption from cash settlement to share settlement.

Additional resources:

- PwC's *Financial statement presentation* guide, Chapter 7

Fair value measurements

QUESTION 5.1

If there is a quoted price in an active market (that is, a level 1 input), can a company adjust or disregard the quoted price in a period of significant market volatility when determining the fair value of an investment?

PwC response

The objective of "fair value" is to determine a price at which an orderly transaction would take place between market participants under conditions that existed at the measurement date. It would not be appropriate to adjust or disregard observable transactions, unless those transactions are determined to not be orderly. Generally, there is a high bar to conclude that a transaction price is not orderly under ASC 820. Although ASC 820-10-35-54I provides a list of factors to consider that may indicate a transaction is not orderly, we believe there is an implicit rebuttable presumption that observable transactions between unrelated parties are orderly. In our experience, such transactions are considered to be orderly in almost all instances. Therefore, the evidence necessary to conclude an observable transaction between unrelated parties is not orderly should be incontrovertible. Accordingly, we would expect that the fair value of an investment in an active market would continue to be calculated as the product of the quoted price for the individual instrument times the quantity held (commonly referred to as “P times Q”), even in times of significant market volatility.

QUESTION 5.2

Can a company disregard market prices of assets in an inactive market in periods of market volatility when determining the fair value of an investment?

PwC response

ASC 820-10-35-54C through ASC 820-10-35-54H address valuations in markets that were previously active, but are inactive in the current reporting period. This guidance provides additional factors to consider in measuring fair value when there has been a significant decrease in market activity for an asset or a liability and quoted prices are associated with transactions that are not orderly. For those measurements, pricing inputs for referenced transactions may be less relevant. A company should determine if a pricing input for an inactive security was orderly and representative of fair value by assessing if it has the information to determine that the transaction is not forced or distressed. If it cannot make that determination, the input needs to be considered; however, the input may be less relevant to the measurement than other transactions which are known to be orderly.

Transactions between unrelated parties are considered to be orderly in almost all instances. Accordingly, unless there is incontrovertible evidence that a transaction is not orderly, the company must consider the transaction in determining fair value. The fair value standards do not prescribe a methodology for making significant adjustments to transactions or quoted prices when estimating fair value in inactive markets. Instead of applying a prescriptive approach, companies should weight indicators of fair value.

QUESTION 5.3

COVID-19 disruptions could cause delays in the availability of information used to measure the fair value of an investment. If a company uses estimates of such information in its initial valuation assessment, how should a company consider updated information that becomes available before its financial statements are issued?

PwC response

For information used in fair value models, initial estimates should be updated for any delayed information that becomes available prior to the release of the company’s financial statements if the information provides additional evidence about known or knowable conditions that existed at the measurement date. See Question 5.4 for when information about net asset value is received after the measurement date.

QUESTION 5.4

What should a company do if net asset value (NAV) is not available as of the measurement date for a fund investment measured using NAV as a practical expedient?

PwC response

The NAV of an investee fund should be based on the measurement principles of ASC 946, *Financial Services—Investment Companies,* and determined as of the company's balance sheet date (i.e., the measurement date). If NAV information as of that date is not available, including because of delays resulting from COVID-19 disruptions, the reporting entity may use the most recently available reported NAV, adjusted for known and estimated changes in NAV between that date and the balance sheet date. In addition to known capital activity, an adjustment may be necessary for estimated changes in the fair value of the investee's portfolio resulting from changes in market or other economic conditions. Reporting entities will be required to use judgment in determining what adjustments may be necessary in light of the economic impacts of COVID-19.

To the extent that additional information about the balance sheet date NAV, including audited financial statements, becomes available prior to the issuance of the company's financial statements, that information should be used in the determination of the appropriate NAV measurement as of the balance sheet date.

Additional resources:

- PwC's *Fair value measurements* guide

Financial asset impairments

The impairment model for financial assets depends on the type of asset. The model for some assets was impacted by adoption of ASC 326, *Financial Instruments—Credit Losses*, which was effective for calendar year-end SEC filers (other than smaller reporting companies) on January 1, 2020.

Type of asset	Model	Challenges due to current environment
Financial assets measured at amortized cost (including loans, held-to-maturity debt securities and trade receivables) and certain off-balance sheet items, such as loan commitments / credit guarantees	Current expected credit losses (CECL): estimate credit losses expected over the "life" of an asset (or pool of assets) Consider: • Historical & current information • Reasonable and supportable forecasts	Determining impact of market events on reasonable and supportable forecast assumptions, including macroeconomic forecasts Changes to collateral values / sector impacts, etc. Changes to expected life

Type of asset	Model	Challenges due to current environment
	of future events and circumstances • Estimates of prepayments • Certain contractually provided extension options	of loans (e.g., prepayments) Model requires consideration of reasonably expected troubled debt restructurings First period of required qualitative and quantitative disclosures, including a description of how the allowance was determined
Available-for-sale debt securities	Credit allowance may need to be established if the fair value of the debt security is less than its amortized cost basis Allowance established at security level	First period of required disclosures Requires discounted cash flow analysis to evaluate for credit loss when fair value is below amortized cost; many use qualitative filters that may not be designed for the current environment
Equity instruments at fair value	Measured at fair value each period with changes recorded in earnings	Determination of fair value may require additional judgment
Equity instruments under the measurement alternative	Remeasurement to fair value required when there is an impairment or there are observable price changes in orderly transactions for the identical or similar investment of the same issuer investment of the same issuer	Impairment model is qualitative; using indicators and determination of fair value upon impairment will require judgment Market activity may result in additional observable transactions requiring remeasurement to fair value in additional observable transactions requiring remeasurement to fair value

Type of asset	Model	Challenges due to current environment
Equity method investments	Impairment charge recognized in earnings when the decline in value below the carrying amount is determined to be other than temporary	Determination of whether the investment is other than temporarily impaired will require judgment given market decline Considerations of (1) duration and severity of market value being less than cost, (2) financial condition and near-term prospects of the investee, and (3) the intent and ability to retain investment for a period of time sufficient to allow for any anticipated recovery in market value

Debt securities

QUESTION 6.1

How should a company determine whether an allowance is necessary for an available-for-sale security (post-ASC 326)?

PwC response

An available for sale security is considered impaired if the fair value of the security is less than its amortized cost basis.

If a company concludes that it does not intend to sell an impaired security (and it is not more likely than not required to sell an impaired security) before recovery of its amortized cost basis, a company determines whether any portion of the impairment relates to credit losses (if any). If so, an allowance for credit losses is established with an offsetting entry to net income. This is determined based on an analysis of the present value of contractual cash flows expected to be collected as compared to the amortized cost basis. Any portion of the impairment not related to credit losses would be recorded through other comprehensive income. The amount of the allowance for credit losses is limited to the amount fair value is less than the amortized cost basis. In practice, in applying the guidance, many companies may evaluate whether an allowance may be necessary based upon qualitative filters (e.g., credit rating). Given current events, those filters may not be sufficient to identify credit losses.

If the security is impaired and the company intends to sell (or will more likely than not be required to sell) the security before recovering its amortized cost basis, a company should first write off any previously recognized allowance for credit losses with an offsetting entry to the security's amortized cost basis. If the allowance has been fully written off and fair value is less than amortized cost basis, a company should directly write down the amortized cost basis of the asset to its fair value with an offsetting entry to net income.

QUESTION 6.2

For held-to-maturity and available-for-sale debt securities, how should companies consider whether declines below carrying value are other than temporary (pre-ASC 326)?

PwC response

An investment in a debt security is considered impaired if the security's fair value is less than its amortized cost at the balance sheet date. Prior to the adoption of ASU 2016-13, if impairment exists, the accounting and reporting model, including the determination of whether that impairment is "other than temporary," differs depending on the facts and circumstances.

If a debt security is impaired, additional analysis is needed to determine whether the impairment is temporary or other than temporary (OTTI):

- If an investor intends to sell an impaired debt security, the impairment is considered to be other than temporary. The impairment would be measured as the difference between fair value and amortized cost.
- If an investor does not intend to sell the impaired debt security, the investor must consider available evidence to assess whether it will more likely than not (MLTN) they will be required to sell the security before the recovery of its amortized cost basis (e.g., whether its cash or working capital requirements, or contractual or regulatory obligations, indicate the security will be required to be sold before a forecasted recovery occurs). If the investor will MLTN be required to sell the security before recovery of its amortized cost basis, the impairment is considered to be other than temporary. The impairment would be measured as the difference between fair value and amortized cost.

If the investor does not intend to sell the impaired security and it is not MLTN that the investor will be required to sell the impaired security, an analysis should be performed to determine whether a credit loss exists. In assessing whether a credit loss exists, an investor must compare the present value of cash flows expected to be collected from the security with the amortized cost basis of the security. If the present value of the cash flows expected to be collected is less than the amortized cost basis of the security, the entire amortized cost basis of the security will not be recovered (i.e., a credit loss exists), and an other-than-temporary impairment is considered to have occurred. The impairment recorded in earnings would be based on the difference between the amortized cost basis and present value of future cash flows. In practice, in applying the guidance, many companies may evaluate whether an impairment is necessary based upon qualitative filters (e.g., credit rating). Given current events, those filters may not be sufficient to identify credit losses.

Equity investments

QUESTION 6.3

How does the market downturn impact the accounting for equity instruments when a company applies the measurement alternative?

PwC response

When a company elects the measurement alternative in ASC 321, the equity interest is recorded at cost, less impairment. The carrying amount should be subsequently remeasured to its fair value in accordance with the provisions of ASC 820 when observable price changes (i.e., observable prices in orderly transactions for an identical or similar investment of the same issuer) occur as of the date the transaction occurred or it is impaired. Any adjustments to the carrying amount are recorded in net income. Companies should be alert for observable transactions as investors may be adjusting their investment strategies in light of the current economic environment.

An ongoing assessment will need to be performed to determine whether an equity interest for which the measurement alternative has been elected has become impaired. The instrument is impaired if based on a qualitative assessment of impairment indicators, the fair value of the equity interest is less than its carrying amount. If considered impaired, the difference between the carrying amount and fair value should be recorded in net income.

Given the current economic environment, companies should consider whether the fair value of the equity instrument could be below its amortized cost basis. In assessing an equity investment for impairment, the measurement alternative model does not include a significance threshold or the ability to avoid an impairment if a company believes the decline in fair value is temporary. ASC 321 does not include the concept of "other than temporary" as it relates to an impairment assessment. The impairment model under ASC 321 is a one-step impairment model under which a company should compute the fair value of an equity investment in accordance with ASC 820 if it has reason to believe the investment's fair value is below the carrying value. If the equity investment's fair value is below the carrying value, the company must record an impairment for the difference.

The impairment charge is a basis adjustment that reduces the carrying amount of the equity interest to its fair value. It is not a valuation allowance. The carrying amount of an equity interest should be remeasured to fair value (even if the equity interest has previously been impaired) if there is an observable price from an orderly transaction for identical or similar security from the same issuer or an additional impairment.

QUESTION 6.4

When should a company record an impairment charge for an equity method investment?

PwC response

A company should record an impairment charge in earnings when there is a decline in the fair value of the investment below its carrying amount that is other than temporary. The unit of account for assessing whether there is an other-than-temporary impairment (OTTI) is the carrying value of the investment as a whole.

All available evidence should be considered in assessing whether a decline in value is other than temporary. The relative importance placed on individual facts may vary depending on the situation. Factors to consider in assessing whether a decline in value is other than temporary include:

- the length of time (duration) and the extent (severity) to which the market value has been less than cost,
- the financial condition and near-term prospects of the investee, including any specific events that may influence the operations of the investee, such as changes in costs for raw materials for their product or decreases in demand for their products that may affect the future earnings potential, and
- the intent and ability of the investor to retain its investment in the investee for a period of time sufficient to allow for any anticipated recovery in market value.

Consideration should also be given to the reasons for the impairment and the period over which the investment is expected to recover. The longer the expected period of recovery, the stronger and more objective the positive evidence needs to be in order to overcome the presumption that the impairment is other than temporary.

Once a determination is made that an OTTI exists, the investment should be written down to its fair value in accordance with ASC 820, *Fair Value Measurements*, which establishes a new cost basis. Therefore, the use of an "undiscounted cash flow" approach is not an appropriate means of assessing the amount of an impairment charge. In addition, bifurcation of declines in value between "temporary" and "other than temporary" is not allowed.

Fair value is determined at the reporting date for the purposes of an impairment, regardless of whether the investor accounts for the investment on a lag. Therefore, subsequent declines or recoveries after the reporting date are not considered in the determination of fair value. A previously recognized OTTI cannot subsequently be reversed if fair value increases above the original carrying amount.

When an investor records an OTTI, the investor is required to attribute the impairment charge to the underlying equity method memo accounts of its investment. The attribution may create new basis differences, increase existing basis differences, or reduce existing basis differences. ASC 323, *Investments—Equity Method and Joint Ventures*, does not provide guidance on attributing the amount of an OTTI to the investor's equity method memo accounts. We believe there are several acceptable methods to attribute the charge; however, the method applied should be reasonable and applied consistently.

Current expected credit losses (CECL)

QUESTION 6.5

Given the rapidly evolving nature of recent economic and market events, what should companies consider in developing their estimate of current expected credit losses as of December 31?

PwC response

CECL requires companies to consider current conditions and reasonable and supportable forecasts in developing an estimate of expected credit losses. This estimate requires the use of judgment, especially in times of economic uncertainty.

Companies should update their models and estimates to reflect the revised economic outlooks, perform sensitivity analyses based on the new forecasts, adjust probability weighting on alternative scenarios, consider qualitative adjustments, and/or provide additional disclosures. In addition, the CECL model requires consideration of all of the effects of a troubled debt restructuring (TDR) on estimated credit losses when it has a reasonable expectation at the reporting date that it will execute a TDR with the borrower.

Companies should also consider the impact of current conditions and economic forecasts relating to specific sectors, geographical areas, and borrower-specific exposures. Factors to consider include whether models reflect specific risks, whether data used in estimates (e.g., ratings or other indicators) reflect current conditions and reasonable and supportable forecasts, and changes in the value of any collateral.

Following a systematic and well-documented process consistent with the guidance in SEC Staff Accounting Bulletin No. 119 will continue to be important in developing the estimate for credit losses as of December 31. In addition, it will be important for companies to provide transparent disclosures on the impact of the current economic environment including assumptions used and their impact on the estimate for credit losses.

QUESTION 6.6

An entity adopted ASU 2016-13, Financial Instruments - Credit Losses, *on January 1, 2020. In accordance with this guidance, the impact of adoption was recorded as an adjustment to opening retained earnings. Should the company consider recent economic events, including the impact of COVID-19, as part of the transition adjustment?*

PwC response

No. ASC 855-10-55-2(e) (as amended) states that "[c]hanges in estimated credit losses on receivables arising after the balance date but before financial statements are issued or are available to be issued" are nonrecognized subsequent events.

In calculating the transition adjustment, the company should consider economic conditions and forecasts as of the date of transition (January 1, 2020). The impact of changes in economic conditions and forecasts after this date on a company's estimate of current expected credit losses should be reflected in the following reporting period (first quarter 2020) and would not be reported as part of the transition adjustment.

Additional resources:

- PwC's *Loans and investments* guide
- PwC's *Financial statement presentation* guide, Chapter 9 (pre-ASC 326)

Financial statement presentation

QUESTION 7.1

How should incremental costs incurred related to the impact of the COVID-19 pandemic be presented in the financial statements?

PwC response

ASC 220-20-45-1 provides guidance for reporting events that are unusual and infrequent. If a company concludes that a material event is of an unusual nature and/or occurs infrequently, it should be reported as a separate component of income from continuing operations in the income statement or disclosed in the notes to the financial statements. This guidance also prohibits net-of-tax reporting (including per-share effects) of such items on the face of the income statement.

For these purposes, *unusual nature* is defined as possessing a high degree of abnormality and clearly unrelated to, or only incidentally related to, the ordinary and typical activities of the company. *Infrequent* means that the event should not be reasonably expected to recur in the foreseeable future. Both of those characteristics are, therefore, highly dependent on the environment in which a company operates.

In the context of the COVID-19 pandemic, while the scope and severity of the economic impacts may be significant to many entities, it is important to consider that many of those impacts are a function of inherent economic uncertainty that is present in all circumstances (e.g., demand risk, geopolitical influences on sources of supply). Nevertheless, it is likely that many companies will consider some of the effects of the COVID-19 pandemic to, at a minimum, be infrequent even if not of an unusual nature. ASC 220-20 does not provide guidance on how to quantify the impact of a material event that is of an unusual nature and/or infrequent, and, thus, determining the incremental amount it is a matter of significant judgment. We believe that a reasonable approach would be to identify those impacts that are direct and incremental related to the COVID-19 pandemic (e.g., severance). Costs that would be incurred with or without COVID-19 would likely not be direct and incremental (e.g., overhead, payroll and benefits). For certain costs, judgment will be required to determine what is incremental (e.g., expenses associated with furloughed employees, as discussed in Question 1.3).

Lastly, a company that separately presents the financial impact of the COVID-19 pandemic should pay special attention to any subtotals, such as gross profit or operating income. For example, although presentation of a gross profit subtotal is not required under Regulation S-X Rule 5-03, certain costs, such as impairment of inventory, are required to be included in costs of sales (and, thus, in gross profit, if presented) as discussed in ASC 420-10-S99-3. In addition, although presentation of a subtotal for operating income is not required under Rule 5-03, if a registrant chooses to present an operating income subtotal, charges that relate to activities for which the revenues and expenses have historically been included in operating income should generally be classified as an operating expense and separately disclosed if material. We believe that most costs of the COVID-19 pandemic should be included in operating income or operating profit if such a subtotal is presented.

Foreign currency

QUESTION 8.1

How should a company account for a foreign currency-denominated intercompany loan designated as being of a long-term investment nature, when the company can no longer support the assertion that the loan will not be paid in the foreseeable future?

PwC response

When management asserts that a foreign currency-denominated intercompany loan will *not* be settled in the foreseeable future, the gains and losses from remeasuring the intercompany loan into the company's functional currency (transaction gains and losses) should be recorded in the cumulative translation adjustments (CTA) account when the entities are consolidated, combined, or accounted for by the equity method in the reporting entity's financial statements (i.e., the gains and losses are recorded in the same manner as translation adjustments). If management can no longer assert that the loan will not be repaid in the foreseeable future, the company can no longer record the transaction gains or losses in the same manner as translation adjustments. Management should also consider the tax accounting implications of the change in assertion . This change in accounting should be made on a prospective basis from the date that the company's assertion changed. Amounts previously recorded in the cumulative translation adjustment (CTA) account should remain in CTA until such time as the foreign entity (as defined in ASC 830) is sold or substantially liquidated.

Repatriation of cash and restructuring of legal entities are events that could cause a company to reconsider its assertions over loans designated as being of a long-term investment nature. These are events that could result from the decreased economic activity due to the impact of COVID-19.

Additional resources:
• PwC's *Foreign currency* guide

Goodwill, indefinite-lived intangibles, and long-lived assets

COVID-19 may impact a company's projected cash flows due to a decrease in demand for its product, supply chain disruptions, or other events. In such situations, a company needs to consider whether the disruption in its business indicates that a "triggering event" has occurred. If it has, an impairment assessment is warranted and the assumptions and cash flow forecasts used to test for impairment should be updated to reflect the potential impact of COVID-19. Budgets, forecasts, and other assumptions should reflect the increased risk and uncertainty.

Companies should also be mindful of the need to file a Form 8-K (Item 2.06) within 4 business days after a decision is made to record a material charge for impairment to one or more of its assets, including impairments of securities or goodwill. However, no filing is required under Item 2.06 if the conclusion is made in connection with the preparation, review or audit of financial statements required to be included in the next periodic report, if the periodic report is filed on a timely basis and the conclusion is disclosed in the report. For example, a filing may not be required if an impairment was identified as part of the preparation of the Q1 2020 interim financial statements and was disclosed in a timely filed Form 10-Q.

QUESTION 9.1

What events may indicate the need to perform an impairment test of intangible and tangible assets?

PwC response

The nature and need for an impairment test will vary depending on the type of asset. The following chart summarizes the requirements for impairment testing under ASC 350, *Intangibles - Goodwill and Other*, and ASC 360, *Property, Plant, and Equipment*.

	Goodwill	Indefinite-lived intangible assets	Amortizable intangible assets and other long-lived assets
Accounting standard	ASC 350	ASC 350	ASC 360
Frequency	Annual / Trigger based	Annual / Trigger based	Trigger based
Methodology	One step*	One step	Two step
Focus	Fair value of the reporting unit*	Fair value of the Individual asset	Recoverability of carrying amount of the asset
Additional guidance	BCG 9.5	BCG 8.3	PPE 5

* Assumes adoption of ASU 2017-04, *Simplifying the Test for Goodwill Impairment*

ASC 350-20-35-3C lists the following examples of indicators for when an interim impairment test of goodwill may be required:

Excerpt from ASC 350-20-35-3C

a. Macroeconomic conditions, such as a deterioration in general economic conditions, limitations on accessing capital, fluctuations in foreign exchange rates, or other developments in equity and credit markets

b. Industry and market considerations, such as a deterioration in the environment in which an entity operates, an increased competitive environment, a decline in market-dependent multiples or metrics (consider in both absolute terms and relative to peers), a change in the market for an entity's products or services, or a regulatory or political development

c. Cost factors such as increases in raw materials, labor, or other costs that have a negative effect on earnings and cash flows

d. Overall financial performance, such as negative or declining cash flows or a decline in actual or planned revenue or earnings compared with actual and projected results of relevant prior periods

e. Other relevant entity-specific events such as changes in management, key personnel, strategy, or customers; contemplation of bankruptcy; or litigation

f. Events affecting a reporting unit such as a change in the composition or carrying amount of its net assets, a more-likely-than-not expectation of selling or disposing of all, or a portion, of a reporting unit, the testing for recoverability of a significant asset group within a reporting unit, or recognition of a goodwill impairment loss in the financial statements of a subsidiary that is a component of a reporting unit

g. If applicable, a sustained decrease in share price (consider in both absolute terms and relative to peers).

According to ASC 350-30-35-18, “An intangible asset not subject to amortization shall be tested for impairment annually or more frequently if events or changes in circumstances indicate that it is more likely than not that the asset is impaired.” ASC 350-30-35-18B provides the following examples of events that could affect the significant inputs used to determine the fair value of the indefinite-lived intangible asset.

Excerpt from ASC 350-30-35-18B

a. Cost factors such as increases in raw materials, labor, or other costs that have a negative effect on future expected earnings and cash flows that could affect significant inputs used to determine the fair value of the indefinite-lived intangible asset

b. Financial performance such as negative or declining cash flows or a decline in actual or planned revenue or earnings compared with actual and projected results of relevant prior periods that could affect significant inputs used to determine the fair value of the indefinite-lived intangible asset

c. Legal, regulatory, contractual, political, business, or other factors, including asset-specific factors that could affect significant inputs used to determine the fair value of the indefinite-lived intangible asset

d. Other relevant entity-specific events such as changes in management, key personnel, strategy, or customers; contemplation of bankruptcy; or litigation that could affect significant inputs used to determine the fair value of the indefinite-lived intangible asset

e. Industry and market considerations such as a deterioration in the environment in which an entity operates, an increased competitive environment, a decline in market-dependent multiples or metrics (in both absolute terms and relative to peers), or a change in the market for an entity’s products or services due to the effects of obsolescence, demand, competition, or other economic factors (such as the stability of the industry, known technological advances, legislative action that results in an uncertain or changing business environment, and expected changes in distribution channels) that could affect significant inputs used to determine the fair value of the indefinite-lived intangible asset

f. Macroeconomic conditions such as deterioration in general economic conditions, limitations on accessing capital, fluctuations in foreign exchange rates, or other developments in equity and credit markets that could affect significant inputs used to determine the fair value of the indefinite-lived intangible asset.

A long-lived asset and intangible assets subject to amortization should be tested for recoverability when events or changes in circumstances indicate that its carrying amount may not be recoverable. ASC 360-10-35-21 includes the following examples of such events or changes in circumstances:

Excerpt from ASC 360-10-35-21

a. A significant decrease in the market price of a long-lived asset (asset group)

b. A significant adverse change in the extent or manner in which a long-lived asset (asset group) is being used or in its physical condition

c. A significant adverse change in legal factors or in the business climate that could affect the value of a long-lived asset (asset group), including an adverse action or assessment by a regulator

d. An accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of a long-lived asset (asset group)

e. A current-period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with the use of a long-lived asset (asset group)

f. A current expectation that, more likely than not, a long-lived asset (asset group) will be sold or otherwise disposed of significantly before the end of its previously estimated useful life.

QUESTION 9.2

Company management has considered the events and circumstances described in ASC 350-20-35-3C and does not believe an interim triggering event has occurred. As a result, can management conclude that it does not have a requirement to perform an interim impairment test for goodwill?

PwC response

The indicators listed in ASC 350-20-35-3C are examples, and are not an exhaustive list. ASC 350-20-35-3F indicates that an entity should consider other relevant events and circumstances that affect the fair value or carrying amount of a reporting unit.

Additional examples of events that may indicate that an interim impairment test is necessary include:

- Impairments of other assets or the establishment of valuation allowances on deferred tax assets
- Cash flow or operating losses at the reporting unit level (the greater the significance and duration of losses, the more likely it is that a triggering event has occurred)
- Negative current events or long-term outlooks for specific industries impacting the company as a whole or specific reporting units
- Not meeting analyst expectations or internal forecasts in consecutive periods, or downward adjustments to future forecasts

- Planned or announced plant closures, layoffs, or asset dispositions
- Market capitalization of the company below its book value

Therefore, only after considering all available evidence can a company conclude that it does not have a requirement to perform an interim impairment test for goodwill.

QUESTION 9.3

If a company's market capitalization is below its book value, is this a triggering event to perform an interim goodwill impairment analysis?

PwC response

Not necessarily. While market capitalization generally reflects the market's expectations of future cash flows of a company, the goodwill impairment assessment is performed at the reporting unit level. An impairment assessment is performed if a company determines that it is "more likely than not" that the fair value of a reporting unit is less than its carrying amount. When a substantial decline in market capitalization occurs, a company may need to consider whether its projections reflect current expectations of recent economic conditions.

A decline in market capitalization that is severe, even if it is recent, as a result of an event that is expected to continue to affect the company (e.g., reduction in customer demand) may trigger the need for a test.

QUESTION 9.4

If a company experiences a decline in market capitalization that is consistent with declines experienced by others within its industry, is it reasonable for the company to assert that a triggering event has not occurred, as the decline is an indication of distressed transactions and not reflective of the underlying value of the company?

PwC response

There are times when a distressed transaction may be put aside. However, a distressed market cannot be ignored. A decline in a company's market capitalization consistent with declines experienced by others within its industry may be reflective of the underlying value of the company in a distressed market. Entities should distinguish between a distressed market, in which prices decline yet liquidity exists with sufficient volume, and a forced or distressed transaction. Transactions at depressed prices in a distressed market would not typically be distressed transactions. Refer to Question 9.11 for more information.

QUESTION 9.5

When calculating a goodwill impairment, how are deferred tax assets considered?

PwC response

Taxable business combinations can generate goodwill that is deductible for tax purposes. When such goodwill is impaired for financial reporting purposes, there may be an impact on deferred taxes. In these cases, ASC 350-20-55-23A through ASC 350-20-55-23D illustrates a simultaneous equation method that should be used to determine the goodwill impairment loss and associated income tax benefit.

QUESTION 9.6

Does it matter in which order a company performs its impairment testing of goodwill and other long-lived assets?

PwC response

Yes. If goodwill and long-lived assets of a reporting unit that are held and used (as opposed to held for sale) are tested for impairment at the same time, the impairment testing should be performed in the following order:

1. Assets and liabilities not covered by ASC 360 (including indefinite-lived intangible assets (other than goodwill in the scope of ASC 350))
2. Long-lived assets in the scope of ASC 360
3. Goodwill

The carrying values are adjusted, if necessary, for the result of each test prior to performing the next test. If an asset group is held for sale, goodwill should be tested before long-lived assets covered by ASC 360.

QUESTION 9.7

If production facilities are idle, should a company consider changes in depreciation?

PwC response

Depreciation ceases when an asset is derecognized or when the asset is classified as held for sale in accordance with ASC 360-10-35-43. Facilities that are temporarily vacant or idle due to COVID-19 should continue to be depreciated. However, if an asset or component of an asset remains idle for more than a short period of time, it may indicate a potential impairment or demonstrate the need to reassess the asset's useful life.

QUESTION 9.8

When a company has committed to abandon a right-of-use asset, should the remaining useful life of the right-of-use asset be reconsidered?

PwC response

Yes. Adjustment of the useful life of the to-be-abandoned asset may be necessary in accordance with ASC 360-10-35-47. The useful life assessment of a long-lived asset is based on the lessee's assumption of the length over which it intends to use the asset. Refer to section 4.2.1 in PwC's *Property, plant, equipment and other assets* guide for more information.

If a right-of-use asset has not been impaired but its useful life has been shortened, one acceptable approach to subsequently account for the lease is to follow the accounting for a right-of-use asset that has been impaired. Under this approach, amortization of the right-of-use asset and lease liability would be delinked in the subsequent accounting. Refer to Example PPE 6-12 in our *Property, plant, equipment and other assets* guide for an illustration of this delinked approach.

Another acceptable approach to subsequently account for the lease is to retain the linkage between the right-of-use asset amortization and the lease liability. In this case, the straight-line lease expense would be remeasured over the shortened useful life, which is consistent with the guidance in ASC 842-20-25-6(a). Refer to Example PPE 6-13 in our *Property, plant, equipment and other assets* guide for an illustration of this linked approach.

QUESTION 9.9 (added January 2021)

When a lessee decides to cease use of leased space, either immediately or at some point in the future, it will need to consider whether the associated right-of-use asset is or will be abandoned. For the purposes of evaluating whether the right-of-use asset is or will be abandoned, what is the impact of a lessee's intent and practical ability to sublease the space?

PwC response

The determination of whether a right-of-use asset is or will be abandoned under ASC 360-10 is an entity-specific evaluation. When a lessee decides to cease using leased space either immediately or in the future, it will need to consider whether the right-of-use asset is or will be abandoned. Temporarily idling a right-of-use asset (e.g., leaving leased space unoccupied with plans to return at a future date) is not considered an abandonment. Similarly, vacating leased space with plans to sublease the space in the future does not constitute an abandonment of the right-of-use asset because the lessee could potentially economically benefit from the right-of-use asset in the future.

In certain situations, such as when there is an oversaturation of supply in the real estate market, a lessee may not be able to sublease the vacated leased space despite having the contractual ability to do so. In this scenario, judgment is required to support an abandonment conclusion. For example, when a lessee has a significant remaining lease term, it may be difficult to support abandonment, especially when a reasonable party would likely attempt to economically benefit from the leased space at some point in the future, such as through subleasing or another alternative use. On the other hand, when there is an insignificant remaining lease term and the lessee can support that the leased space will not be used, or there is no reasonable possibility of subleasing at any point for the remainder of the lease term, abandonment accounting may be appropriate.

QUESTION 9.10

What is the accounting impact if a right-of-use asset becomes impaired because it is in an asset group that becomes impaired?

PwC response

Once a right-of-use (ROU) asset for an operating lease is impaired, lease expense will no longer be recognized on a straight-line basis. ASC 842-20-35-10 requires delinking the amortization of the ROU asset and lease liability. A lessee should continue to amortize the lease liability using the same effective interest method as before the impairment charge. The ROU asset, on the other hand, should be subsequently amortized on a straight-line basis. The resulting accounting is similar to the accounting a lessee would apply to a finance lease, however, the lease is still classified as an operating lease, and a lessee should continue to follow operating lease presentation and disclosure guidance. See In depth US2019-01 for additional information.

Fair value of a reporting unit

QUESTION 9.11

If management believes that the current trading price of its stock is not representative of fair value, can a company assert that the market data is not relevant when determining the fair value of a reporting unit?

PwC response

A company's market capitalization and other market data should be considered when assessing the fair value of a company's reporting units. In a depressed economy, declines in market capitalization could represent factors that should be considered in determining fair value, such as an overall re-pricing of the risk associated with the company. However, in inactive markets, market capitalization may not be representative of fair value, and other valuation methods may be required to measure the fair value of a company comprised of a single reporting unit. Determining the factors affecting market capitalization and their impact on fair value requires the application of judgment.

QUESTION 9.12

What is the impact of the current economic environment on the discount rate when using a discounted cash flow technique?

PwC response

The discount rate used in a discounted cash flow technique includes a number of market inputs, including a risk-free rate and a cost of debt. In most jurisdictions, the former has declined significantly in 2020, while the latter has declined for some companies and risen for others. This could result in a lower weighted average cost of capital, and thus discount rate, for many companies. It is important to remember, though, that the discount rate needs to be calibrated to the risks in the cash flow forecast, including the long-term growth rate.

In situations when a company faces a wide range of possible scenarios, it can be difficult to come up with a single cash flow forecast and an appropriate discount rate. In these cases, it may be better to employ an expected cash flow approach (multiple probability-weighted scenarios) to capture the increased risk and uncertainty. The potential impact of measures taken to control the spread of the virus could be included as additional scenarios in an expected cash flow approach. There might be a range of potential outcomes considering different scenarios.

QUESTION 9.13

If a company has historically utilized a market multiple approach in determining the fair value of its reporting units, can it use a discounted cash flow analysis in the current year?

PwC response

Yes. Generally, valuation best practices support the use of multiple valuation techniques when estimating the fair value of a reporting unit. Changing methodologies or changing the weighting when multiple valuation techniques are used would be appropriate if the change results in a measurement that is equally or more representative of fair value in the circumstances. This change would be considered a change in accounting estimate.

QUESTION 9.14

What are common reconciling items between the aggregate fair values of a company's reporting units and its market capitalization?

PwC response

When a difference exists between a company's market capitalization and the aggregate fair values of a company's reporting units, the reasons for the difference should be understood. A common reason for a difference between the aggregate fair values of the reporting units and the company's overall market capitalization is that control premiums associated with a reporting unit are not reflected in the quoted market price of a single share of stock.

Other differences may be linked to external events or conditions, such as broad market reaction to circumstances associated with one or a few reporting companies. For example, the deteriorating financial condition of one company in a particular market sector could cause temporary market declines for other companies in the same sector. Short-term fluctuations in volatile markets may not necessarily reflect underlying fair values. It is therefore important to be able to explain the market fluctuations as part of the reconciliation of market capitalization to the estimated fair values of reporting units. The AICPA Goodwill Guide indicates it is a best practice to identify and document the reasons for differences between the aggregate fair value of reporting units and the observable market capitalization. Factors identified include control synergies, data that may not be available to a market participant, tax consequences, company-specific versus market participant capital structures, excessive short positions against the stock, and controlling or large block interests.

QUESTION 9.15

Could a company reflect the uncertainty of future projections by modeling multiple scenarios, rather than modeling a single scenario that reflects only its best estimate?

PwC response

Yes. ASC 820-10-35-25 indicates that a change in valuation technique is appropriate if it is equally or more representative of fair value in the circumstances. In situations when a company faces a wide range of possible scenarios, it can be difficult to come up with a single cash flow forecast and an appropriate discount rate. For example, a company may determine that financial projections will vary greatly depending on whether or not measures taken to control the spread of the virus are effective.

Additionally, under the single cash flow forecast model, the discount rate reflects the riskiness of the cash flows. That is, the cash flows are discounted to present value using a risk-adjusted rate of return. It is often difficult to establish the company's specific premium that captures this risk. Accordingly, to determine the fair value of a reporting unit, companies may find it easier to capture increased risk and uncertainty with an expected cash flow approach. This involves modeling a range of potential outcomes and probability-weighting each of them.

QUESTION 9.16

How should a company derive the appropriate control premium?

PwC response

The price paid for a controlling interest in a company often exceeds the equivalent trading price of the company's shares. This premium often reflects the ability of a controlling investor to achieve a greater economic benefit than a noncontrolling shareholder.

Control premiums can vary considerably depending on the nature of the business, industry, and other market conditions. Accordingly, determining a reasonable control premium will be a matter of judgment. Generally, when assessing the reasonableness of a control premium, companies should consider the current market conditions with respect to recent trends in their market capitalization, comparable transactions within their industry, the number of potential buyers, and the availability of financing. A well-reasoned and thoroughly documented assessment of the control premium value is necessary and the level of supporting evidence in making this assessment would be expected to increase as the control premium increases from past norms. Further, in light of recent market events, consideration should be given as to whether prior market transactions used to evaluate control premiums would be indicative of future transactions. The use of arbitrary percentages or rules of thumb would not be appropriate.

A control premium is often largely a function of synergies that a market participant would expect to realize by gaining control of the business. Therefore, one way to evaluate the reasonableness of a control premium is to perform a bottom's up approach by identifying areas where market participants could extract savings or synergies by obtaining control. In *Valuations in Financial Reporting Valuation Advisory 3: The Measurement and Application of Market Participant Acquisition Premiums*, the Appraisal Foundation provides a number of examples, including the ability to eliminate duplicative costs, diversify products, grow revenue in new markets, improve distribution channels, and lower risk due to diversification.

When deriving a control premium, it is important to note that the definition of a market participant in ASC 820, *Fair Value Measurement*, refers to one who has a reasonable understanding of the company "using all available information, including information that might be obtained through due diligence efforts that are usual and customary." Therefore, a control premium may reflect this knowledge.

In certain circumstances, it may not be appropriate to compute a control premium based on the average percentage premium of recent transactions within the company's sector, as the value that can be achieved with control may vary by company, even within a sector. Similarly, while it is possible that certain companies may observe a higher control premium in an economic downturn, that determination would be specific to a company's particular facts and circumstances.

Accordingly, increased control premiums in the current market should be carefully evaluated. A larger control premium must be adequately supported and consider the synergies inherent in a market participant's perspective of the fair value of a reporting unit. Only in those instances when a reporting unit could command a higher price in the current market can management consider applying a high control premium. This assessment should be based on all facts and circumstances.

QUESTION 9.17

What are some of the disclosures a company may be required to include in its footnotes related to the impairment analyses for goodwill, indefinite-lived intangibles, and long-lived assets?

PwC response

There are a number of different disclosure requirements that a company should consider related to an impairment or potential impairment in the context of the current environment.

<u>Significant estimates</u>: As discussed in ASC 275-10-50-4 through ASC 275-10-50-8, a company should disclose their use of estimates when the resolution of matters could differ significantly from what is currently expected, and if it is reasonably possible that the estimates will change in the near term and the effect of the change will be material. Given the unprecedented nature of COVID-19, goodwill and other assets may or may not currently be impaired, but depending on the outcome taken to prevent the spread of the virus, the significant estimates used to make these assessments may change in the near term. If such change could be material, disclosure should be included in the footnotes.

<u>Change in methodology</u>: As discussed in ASC 820-10-50-2bbb, a change in a valuation approach or a valuation technique requires disclosure of the change and the reason such change was made. However, for this type of change, the disclosures required by ASC 250 for a change in accounting estimate are not required.

<u>Recognized impairments</u>: Recording an impairment results in an asset reported at fair value. This nonrecurring fair value measurement results in certain required disclosures under ASC 820. For example, ASC 820-10-50-1a requires a company to disclose the valuation techniques and inputs used to determine the fair value. Refer to PwC's *Financial statement presentation* (FSP) guide, Section 20.3.1 for a complete listing of disclosure requirements.

When a long-lived asset is impaired, the company should include the nonrecurring measurement disclosures in (1) the quarter in which the impairment was recorded, (2) its subsequent quarterly filings for the year in which the impairment is recorded, and (3) the annual filings that include the quarter in which the charge was recognized. We believe the approach to include the disclosure in subsequent quarterly filings is consistent with the interim disclosure requirements in Rule 10-01 of Regulation S-X. The primary principle in S-X 10-01 is that the financial statement user will have read the prior year's annual financial statements and the quarterly financial statements should include disclosures for significant events that occurred during the current year, such as impairments. Also, because the year-to-date information is included in each quarterly report, an impairment in one quarter would be recognized in any following quarter's year-to-date information, and thus disclosure when material would be required.

For each long-lived asset, indefinite-lived intangible, or goodwill impairment loss recognized, a company must disclose a description of the facts and circumstances that led to the impairment, the amount of the impairment loss, and the method of determining the fair value along with additional disclosures.

See FSP Sections 8.6.1.1, 8.9.2, and 8.10.2.2 for a complete listing of these disclosures.

QUESTION 9.18

When preparing a company's reconciliation of market capitalization to the sum of the reporting units' fair values, can a company use an average of market prices over a short period of time leading up to the date of impairment testing rather than a single day's market price?

PwC response

Given the recent market conditions, it may be appropriate for a company to consider recent trends in its trading price instead of just a single day's trading price when reconciling to a company's market capitalization. In some cases, share prices may have moved dramatically over a short period of time or there may be a specific event that may impact market prices. Frequently, companies use averages over relatively short periods to determine representative market values. However, companies must carefully evaluate all relevant facts and circumstances. For example, an average may not be appropriate if a company's share price had a steady downward decline. On the other hand, an average may be a reasonable proxy for fair value when share prices experience significant volatility.

Additional resources:

- PwC's *Business combinations and noncontrolling interests* guide
- Valuations in Financial Reporting Valuation Advisory 3: The Measurement and Application of Market Participant Acquisition Premiums
- PwC's *Financial statement presentation* guide
- Robert G. Fox III, Professional Accounting Fellow, Office of the Chief Accountant. SEC, Remarks before the 2008 AICPA National Conference on Current SEC and PCAOB Developments
- Geoff Griffin, Professional Accounting Fellow, Office of the Chief Accountant. SEC, Remarks before the 2020 AICPA Conference on Current SEC and PCAOB Developments
- PwC's *Property, plant, equipment and other assets* guide, Section 6.4.1

Government assistance

(for information on the CARES Act, see our In depth, CARES Act: Accounting for the stimulus)

QUESTION 10.1

Varying levels of government agencies have introduced different relief or stimulus measures to assist companies in responding to the COVID-19 crisis. Government incentives can take a variety of forms, such as direct grants or subsidies; loans, including below-market and/or forgivable loans; tax credits; or some combination. What US GAAP applies to the accounting for government assistance?

PwC response

Outside of the guidance in ASC 740*, Income Taxes,* for investment tax credits or other forms of government assistance that are administered through the income tax regime, and ASC 958-605, *Not-for-profit entities—Revenue recognition—Contributions,* for contributions from the government, US GAAP contains no specific guidance on the accounting for government assistance. Thus, determining the proper accounting treatment for government incentives by business entities can be challenging and will likely depend on a careful analysis of the nature of the assistance and the conditions on which it is predicated.

ASC 958-605 provides guidance on accounting for government contributions to not-for-profit entities. In addition, certain elements of ASC 958-605 provide guidance for contribution transactions for business entities. However, non-exchange transactions (e.g., grants) between the government and a business entity are explicitly excluded from the scope of ASC 958-605. Nevertheless, ASC 958-605 is part of US GAAP, which may be an appropriate analogy for non-exchange transactions for business entities (see Question 10.3).

QUESTION 10.2

What forms of government assistance are subject to the scope of ASC 740, Income taxes*?*

PwC response

While many forms of government credits and incentives may be codified in tax law and may, for administrative purposes, be claimed on a tax return, they may not be subject to ASC 740. A number of features can make these credits and incentives more akin to a government grant or subsidy (see Question 10.3).

The application of income tax accounting is warranted if a particular credit or incentive can be claimed only on the income tax return and can be realized only through the existence of taxable income. When there is no connection to income taxes payable or taxable income (i.e., the credits are realizable in cash by the entity regardless of whether the entity has an income tax liability), we believe the benefit should be accounted for outside of ASC 740.

QUESTION 10.3

How should a business entity account for government assistance that is not accounted for under ASC 740 (e.g., grants, employee retention credits)?

PwC response

There is no US GAAP that specifically addresses the accounting by business entities for government assistance. Thus, determining the proper accounting treatment for government incentives by business entities can be challenging and will likely depend on an analysis of the nature of the assistance and the conditions on which it is predicated.

ASC 105, *Generally Accepted Accounting Principles,* describes the decision-making framework when no guidance exists in US GAAP for a particular transaction. Specifically, ASC 105-10-05-2 instructs companies to first look for guidance for a similar transaction or event within US GAAP and apply that guidance by analogy. If no guidance for similar transactions is identified, a company may consider nonauthoritative guidance from other sources (for example, guidance issued by other standard-setters). In this context, IFRS includes a specific standard, IAS 20, *Accounting for Government Grants and Disclosures of Government Assistance,* that may be relevant.

ASC 958-605 contains the US GAAP on grant accounting, including guidance on evaluating whether government grants are exchange or nonexchange transactions. However, ASC 958-605 excludes from its scope transfers of assets from governments to business entities. As a result, forms of government assistance provided to business entities would not be in the scope of ASC 958-605, but it may be applied by analogy under ASC 105-10-05-2.

Alternatively, companies may look to IAS 20. ASC 958-605 and IAS 20 differ in a few key areas when it comes to accounting for government grants.

	ASC 958-605	IAS 20
Recognition when conditions are present	When the conditions have been substantially met	When there is reasonable assurance that the entity will comply with the conditions and that the grant will be received
Timing and pattern of recognition	When grant is awarded or, if conditional, immediately once the condition is substantially met. Recipients should also consider whether grantor-imposed restrictions exist	Using a systematic basis over the periods in which the entity recognizes the related expenses or losses that the grants are intended to compensate When the grant becomes receivable if it compensates for expenses or losses already incurred .
Presentation of grant income	Grant income is presented on a gross basis (i.e., grant revenue or other income)	May be reported separately as “other income” or deducted from the related expense

With regard to the evaluation of conditions, IAS 20 does not define “reasonable assurance” but it is generally considered to be similar to the notion of “probable” as used in ASC 450, *Contingencies.* ASC 958-605, however, does not permit a company to consider probability or intent in evaluating whether a condition has been or will be achieved; instead, under ASC 958-605, grant income is recognized only when the condition has been substantially met.

Additional resources:

- PwC’s Dealing with government grants? Here’s what you need to know podcast
- PwC’s COVID-19 and CARES Act accounting for healthcare providers (updated on July 23, 2020)

Insurance

QUESTION 11.1

When can companies record the expected recovery under business interruption insurance?

PwC response

Business interruption insurance policies (e.g., loss of use of property or equipment) generally cover losses of gross profit or reimbursement of certain expenses while a company is unable to conduct its business. When a business is interrupted, the writedown of an asset or the accrual of an obligation (e.g., salaries paid to idle workers) would be considered a loss recognized in the financial statements. An insurance recovery for that loss should be recorded when the realization of the claim for recovery is probable.

However, the absence of expected revenue or income is not a loss recognized in the financial statements. Recovery of lost profits or revenue would not be recognized until the contingency is considered resolved. Typically, a business interruption recovery gain would not be recognized prior to the insurance carrier acknowledging that the claim is covered and communicating the amount to be paid to the company. Any stipulation from the carrier (e.g., "pending final review") should be reviewed to determine whether it is an indication the claim may not be realizable. The company's history in collecting such claims should also be considered. When the insured has received payment without the expectation of repayment or refund, the contingency is considered resolved and the gain should be recognized.

When a company incurs losses, typically the party the company owes and the insurer are not the same and the legal right of offset would not exist. Therefore the asset and liability would not be offset in the balance sheet. ASC 220-30-45-1 indicates that companies have a choice in how to classify business interruption insurance recoveries on the income statement as long as the classification is not contrary to other US GAAP. In the statement of cash flows, proceeds related to business interruption policies are operating inflows.

Additional resources:

- PwC's *Property, plant, equipment and other assets* guide, Section 8.2.5
- PwC's *Financial statement presentation* guide, Section 6.9.22

Internal control over financial reporting

QUESTION 12.1

How could current events impact a company's assessment of the effectiveness of its internal control over financial reporting?

PwC response

Current market conditions may heighten the significance of previously identified risks or may result in new risks, particularly market, credit, and liquidity risks. Changes in risks may prompt management to respond by changing the design of its internal controls.

An issuer's disclosure controls and procedures (DC&P) should ensure that material information related to market, credit, and liquidity risks is appropriately reported.

In connection with the quarterly evaluation of the company's DC&P in support of Item 307 of Regulation S-K disclosure requirements, and Sarbanes-Oxley Section 302 and 906 certifications, it may be necessary to reassess whether certain entity-level controls are sufficient to address such risks, given the current market conditions. The following controls, in particular, should be reassessed:

- Risk assessment process
- Policies that address significant business control and risk management policies
- Controls over the period-end financial reporting process
- Controls over management override.

The period-end financial reporting process and controls should be sufficient to ensure that matters that have resulted from current market conditions and that may have a material impact on the issuer are accounted for and disclosed appropriately. Such matters include the following:

- Significant changes in accounting practices
- Changes in significant estimates
- Significant changes in financing arrangements
- Changes in significant risks and uncertainties
- Material contingencies

Because of current market conditions, it may be necessary for companies to make additional disclosures about significant accounting estimates and management judgments, especially those involving valuation and impairment. Estimates and judgments that are based on highly subjective assumptions (e.g., a valuation of financial instruments that is not based on observable market information, assumptions about future events and conditions) may be challenging to develop and also provides the opportunity for management override.

In addition, management should be aware that personnel may not be able to perform controls in the same manner, may be absent, or may lack the information necessary to perform some controls effectively. If a control cannot be performed, appropriate compensating controls at the same level of precision will need to be identified. In implementing responsive changes in assignments and responsibilities, the competency of reassigned resources and segregation of duties should be considered.

Changes in the company's internal control over financial reporting may need to be disclosed. Item 308 of Regulation S-K requires the disclosure of any change in internal control over financial reporting that occurred during the last fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting.

Inventory

QUESTION 13.1

In the current environment, how should a company think about the net realizable value (NRV) of inventory, including purchase commitments?

PwC response

For inventories measured using any method other than LIFO or the retail inventory method, ASC 330-10-35 establishes the lower of cost and net realizable value measurement principle for inventories. A different model (i.e., lower of cost or market) applies for inventories initially measured using LIFO or the retail inventory method (see ASC 330-10-35-1C through ASC 330-10-35-7).

ASC 330 defines "net realizable value" as the estimated selling price in the ordinary course of business less reasonably predictable costs of completion, disposal, and transportation. Additionally, ASC 330-10-35-4 states that no loss should be recognized on inventories unless it is clear that a loss has been sustained.

In applying the lower of cost and NRV principle to raw materials and work-in-progress inventories, it is necessary to estimate the costs to convert those items into saleable finished goods in order to determine NRV. In determining the net amount to be realized on subsequent sales, selling costs should include only direct items, such as shipping and commissions on sales.

Determining NRV at the balance sheet date requires the application of professional judgment, and all available data, including changes in product prices experienced or anticipated subsequent to the balance sheet date, should be considered. For example, a subsequent decrease in prices may indicate the need for an NRV adjustment for inventory on hand at the balance sheet date.

Thus, a decrease in selling price subsequent to the balance sheet date that is not the result of unusual circumstances (see Question 21.2 for an example) generally should be considered in determining NRV at the balance sheet date. See Question 22.1 for additional details on recognized subsequent events for inventory.

ASC 270-10-45-6 and ASC 330-10-55-2 require that inventories be written down during an interim period to the lower of cost and NRV unless substantial evidence exists that the net realizable value will recover before the inventory is sold in the fiscal year. Situations in which an interim write-down would not be necessary are generally limited to seasonal price fluctuations. Given the significant uncertainties associated with the current market conditions, we believe it would be challenging for a company to conclude that such substantial evidence exists.

As detailed in ASC 270-10-45-6, inventory losses from declines in NRV should not be deferred beyond the interim period in which the declines occur if they are not expected to be restored in the same fiscal year. Recoveries of such losses on the same inventory in later interim periods of the same fiscal year should be recognized as gains in the later interim period. Such gains cannot exceed previously recognized losses.

As indicated in SAB Topic 5.BB, based on ASC 330-10-35-14, a write-down of inventory to the lower of cost and NRV at the close of a fiscal period creates a new cost basis that subsequently cannot be marked up based on changes in underlying circumstances after the company's fiscal year-end. Based on this guidance, lower of cost and NRV write-downs recorded during an interim period can be reversed (partially or fully) only in subsequent interim periods of the same fiscal year if NRV recovers.

Losses expected to arise from firm, non-cancelable and unhedged commitments for the future purchase of inventory items should be recognized unless the losses are recoverable through firm sales contracts or other means pursuant to ASC 330-10-35-17 through ASC 330-10-35-18.

QUESTION 13.2

How might decreased production or idle capacity impact inventory costing?

PwC response

Inventory is initially measured at cost, which includes the cost of materials, and, for work-in-process and finished goods, the costs incurred directly or indirectly in production, which includes labor and overhead. Full absorption costing refers to the process of allocating (absorbing) overhead into the cost of inventory.

ASC 330-10-30-1 through ASC 330-10-30-8 indicates that variable production overhead costs should be allocated to each unit of production on the basis of the actual use of the production facilities. The allocation of fixed production overhead costs, however, is required to be based on the "normal capacity" of the production facilities, which is defined as the production expected to be achieved over a number of periods under normal circumstances, taking into consideration loss of capacity resulting from planned maintenance. The range of normal capacity will vary based on business and industry factors.

The amount of fixed overhead costs allocated to each unit of production should not be increased as a consequence of abnormally low production or an idle plant. Abnormal amounts of freight, handling costs, and wasted material (spoilage) should be recognized as current period charges and not included in the cost of inventory. Judgment is required to determine what represents an abnormally low production level and an abnormal amount of production costs.

Additional resources:
• PwC's *Inventory* guide • PwC's *Accounting for inventory: 5 things you need to know* podcast

Leases

COVID-19 has significantly impacted businesses and many lessors are providing and lessees are actively seeking rent concessions. These rent concessions may be in several forms, such as deferral of certain payments, partial or full rent forgiveness for certain periods, cash payment to lessees, extension of lease term, and so on. Some lease agreements may already have a force majeure clause that provides an enforceable right for the lessee to get some rent relief if an unforeseen circumstance occurs. However, the lease agreements may not be very specific about what a force majeure event is and what the rent relief will be in such an event. Therefore, it can be challenging to determine if the rent concession is solely based on a contractual right that the lessee always had in the contract or if the lease terms are being changed to give lease payment relief.

In addition, rights may arise from the laws of the jurisdiction governing the lease agreement or may be mandated by the local or federal government. Lessors can have hundreds or even thousands of leases with numerous lessees who are looking for relief immediately. There may not be time to analyze all of those contracts in detail, which in some cases may also require legal interpretation. The FASB staff has weighed in on the accounting for rent concessions and on April 10 provided some relief in a staff Q&A: *Accounting for Lease Concessions Related to the Effects of the COVID-19 Pandemic*. The following questions are based on that guidance.

QUESTION 14.1

What is the relief provided to lessees and lessors by the FASB staff Q&A when accounting for COVID-19-related rent concessions?

PwC response

If a rent concession is not based on an existing contractual right, lease modification accounting would apply. In most cases, this would require determining if the arrangement meets the definition of a lease, remeasuring and reallocating contract consideration based on revised payment terms to components based on their then-current relative standalone selling price, and reassessing the lease term, discount rate and lease classification at the modification date. A full update of all the assumptions used in accounting for the lease may be challenging for lessors and lessees that have a large population of leases. For more details on lease modification, see PwC's *Leases* guide section 5.2 for lessee lease modification and section 5.6 for lessor lease modification.

Under the relief provided in the FASB staff Q&A, lessees and lessors do not need to evaluate whether a COVID-19-related rent concession is a modification. They may make an election to either account for the concession as a modification or as though it is based on an existing contractual right. In other words, a company will not have to analyze each contract to determine if modification accounting applies. The relief is available for all COVID-19-related rent concessions as long as the rent concessions do not result in an increase in the rights of the lessor or the obligations of the lessee. For example, this relief is available for rent concessions that result in the total payments required by the modified contract being substantially the same as or less than total payments required by the original contract. When evaluating this requirement, consider the following:

- We believe total payments should include the fixed lease payments as well as the expected variable lease payments by a lessee during the lease term, as defined in ASC 842. For more information on fixed lease payments, variable lease payments, and lease term, refer to PwC's *Leases* guide sections 3.3.4.1, 3.3.4.3, and 3.3.3.1, respectively.
- Assessing what is "substantially the same" will require judgment. We believe a difference of no more than 10% between the pre-concession and post-concession cash flows may be a reasonable benchmark.
- We believe the measurement of total payments before and after the rent concession may be on an undiscounted or a discounted basis.

QUESTION 14.2

Is the relief provided to lessees and lessors by the FASB staff Q&A available for a COVID-19-related rent concession that has a payment concession coupled with a lease term extension?

PwC response

Maybe. It will depend on the nature of the extension. For example, if a lessor is giving a payment concession to a lessee for a few months, but adds on a couple of months at the end of the lease term, the total lease payments after the concession may be substantially the same as before the concession. In that case, the relief can be applied. But if there is a longer lease term extension, the total payments after the concession may be substantially more than those before the concession, in which case the relief would not be available.

QUESTION 14.3

Does a company have to apply the relief provided by the FASB staff Q&A available for a COVID-19-related rent concession on an entity-wide basis?

PwC response

No, but the relief should be applied consistently to leases with similar characteristics and in similar circumstances. We do not believe it would be appropriate to “cherry-pick” leases when making the election.

QUESTION 14.4

Are there any required disclosures for COVID-19-related rent concessions?

PwC response

Yes. According to the FASB staff Q&A, disclosures should be provided about material concessions and the accounting effects to enable users to understand the nature and financial effect of the COVID-19 related rent concessions.

QUESTION 14.5

What is the accounting by a lessee for a COVID-19-related rent concession under the relief provided by the FASB staff Q&A when the lessee elects not to account for the concession as a lease modification?

PwC response

In its Q&A, the FASB staff states there may be multiple ways to account for a rent concession that is a deferral in the timing of payments with no substantive changes to the consideration. The Q&A provides two high-level approaches to the accounting for such deferrals. There is no further guidance on how to account for other types of rent concessions when a lessee elects not to account for the concession as a lease modification. We believe acceptable alternatives include the following:

- Account for a deferral in timing of lease payments as if there are no changes in the lease contract

  Under this approach, a lessee would recognize a separate non-interest bearing payable for the deferred payments in the concession period that is settled when the cash is paid at the revised payment date. The lessee would continue to account for the lease liability and right-of-use (ROU) asset as before the rent deferral and there would be no change in the income recognition pattern. The lease liability and ROU asset would amortize to zero by the end of the lease term.

  For example, assume a lessee is required to make a lease payment of $1,000 on the 15th day of each month. In the absence of a concession, on April 15 and May 15, the lessee in an operating lease would have recorded the following journal entry:

Dr. Lease expense	$1,000	
Dr. Lease liability	ZZZ	
Cr. Accumulated ROU asset amortization		$YYY
Cr. Cash		1,000

The lessee in a finance lease would have recorded the following journal entry:

Dr. Interest expense	$XXX	
Dr. ROU asset amortization expense	YYY	
Dr. Lease liability	ZZZ	
Cr. Cash		$1,000
Cr. Accumulated ROU asset amortization		YYY

If the lessor provides a rent concession to the lessee and agrees to defer the April and May payments to October, the only change for both types of leases would be to credit accounts payable instead of cash when the entry is recorded in April and May. In October, the lessee would relieve the $2,000 accounts payable against the payment of cash to the lessor in addition to recording the journal entries for the normal October lease payment.

- Account for rent concessions (including a deferral in the timing of payment) as a resolution of a contingency.

  Under this approach, a lessee would follow the resolution of a contingency model in ASC 842 without reclassifying the lease or updating the discount rate (see PwC's *Leases* guide section 5.3 for more details). The lessee would remeasure the remaining consideration in the contract, reallocate it to the lease and nonelase components as applicable, and remeasure the lease liability with an adjustment to the ROU asset for the same amount. If the total lease payments remain exactly the same, the lease cost will remain unchanged.

- Account for rent concessions (including a deferral in the timing of payment) on an "as incurred" basis

  Under this approach, a lessee would account for a rent concession as a negative variable lease expense in the period to which the concession relates (but not before the concession is legally enforceable) and recognize the expense in the period when the rent is due.

  For example, assume a lessee is required to make a lease payment of $1,000 on the 15th day of each month. In the absence of a concession, on April 15 and May 15, the lessee in an operating lease would have recorded the following journal entry:

Dr. Lease expense	$1,000	
Dr. Lease liability	ZZZ	
Cr. Accumulated ROU asset amortization		$YYY
Cr. Cash		1,000

A lessee in a finance lease would have recorded the following journal entry:

Dr. Interest expense	$XXX	
Dr. ROU asset amortization expense	YYY	
Dr. Lease liability	ZZZ	
Cr. Cash		$1,000
Cr. Accumulated ROU asset amortization		YYY

If the lessor provides a rent concession to the lessee on or before April 15, and agrees to defer the April and May payments to October, the only change for both types of leases would be to credit variable lease expense instead of cash when the entry is recorded in April and May. In October, the lessee would recognize $2,000 in variable lease expense when the cash is paid to the lessor in addition to recording the journal entries for the normal October lease payment.

QUESTION 14.6

What is the accounting by a lessor for a COVID-19-related rent concession under the relief provided by the FASB staff Q&A when the lessor elects not to account for the concession as a lease modification?

PwC response

In its Q&A, the FASB staff states there may be multiple ways to account for a rent concession that is a deferral in the timing of payments with no substantive changes to the consideration. The Q&A provides two high-level approaches to the accounting for such deferrals. There is no further guidance on how to account for other types of rent concessions when a lessee elects not to account for the concession as a lease modification. We believe acceptable alternatives include the following:

- Account for a deferral in timing of lease payments as if there are no changes in the lease contract

  Under this approach, assuming that collectibility of future lease payments is still probable, a lessor would keep the straight-line income recognition unchanged and record a rent receivable until it is settled at the revised payment date.

  For example, assume a lessee is required to make a lease payment of $1,000 on the 15th day of each month and the lessor's straight-line lease income is $1,100. On April 15, in the absence of a concession, the lessor in an operating lease would have recorded the following journal entry:

Dr. Cash	$1,000	
Dr. Rent receivable (unbilled)	100	
Cr. Lease income		$1,100

  A lessor in a sales-type/direct financing lease would have recorded the following journal entries:

Dr. Net investment in the lease	$XXX	
Cr. Lease interest income		$XXX
Dr. Cash	$1,000	
Cr. Net investment in the lease		$1,000

If the lessor provides a rent concession to the lessee and agrees to defer the April and May payments to October, the only change for both types of leases would be to debit an additional receivable instead of cash when the entry is made in April and May. In October, the lessor would relieve the $2,000 rent receivable against payment of cash by the lessee in addition to recording the journal entries for the normal October lease payment.

- Account for rent concessions (including deferral in the timing of payment) on an "as incurred" basis

Operating lease

Under this approach, assuming that collectibility of future lease payments is still probable, a lessor would account for a rent concession as a variable payment on an "as incurred" basis. That is, the lessor would recognize the concession as negative lease income in the period to which the concession relates (but not before the concession is legally enforceable) and recognize the lease income in the period the rent is due.

For example, assume a lessee is required to make a lease payment of $1,000 on the 15th day of each month and the lessor's straight-line lease income is $1,100. On April 15, in the absence of a concession, the lessor would have recorded the following journal entry:

Dr. Cash	$1,000	
Dr. Rent receivable (unbilled)	100	
Cr. Lease income		$1,100

If the lessor provides a rent concession to the lessee on or before April 15, and agrees to defer the April and May payments to October, the lessor would record the following journal entries on April 15 and May 15:

Dr. Rent receivable	$1,000	
Dr. Rent receivable (unbilled)	100	
Cr. Lease income		$1,100
Dr. Lease income	$1,000	
Cr. Rent receivable		$1,000

In October, the lessor would record $2,000 lease income against payment of cash by the lessee in addition to recording the journal entries for the normal October lease payment.

If the probability of collecting future lease payments becomes less than probable at any time during the lease term, the lessor would no longer be able to recognize revenue on a straight-line basis and instead would have to move to a cash basis of accounting. See PwC's *Leases* guide section 8.9 for more information about collectibility of operating lease receivables.

Sales-type/direct financing lease

A lessor would recognize negative variable lease income for the rent concession offset against the net investment in the lease.

For example, assume a lessee is required to make a lease payment of $1,000 on the 15th day of each month. On April 15, without a concession, the lessor would have recorded the following journal entries:

Dr. Net investment in the lease	$XXX	
Cr. Lease interest income		$XXX
Dr. Cash	$1,000	
Cr. Net investment in the lease		$1,000

If the lessor provides a rent concession to the lessee and agrees to defer the April and May payments to October, the lessor would record a debit to lease income instead of to cash in April and May. In October, the lessor would recognize $2,000 lease income when the cash is paid by the lessee in addition to recording the journal entries for the normal October lease payment.

- Account for rent concessions (including a deferral in the timing of payment) as an adjustment of yield prospectively

Under the FASB staff Q&A, lessors may also choose not to treat a rent concession as a modification. We therefore believe it is reasonable for a lessor to change the yield prospectively for a rent concession.

Operating lease

A lessor would remeasure the straight-line lease income prospectively based on the revised payments and include any prepaid or accrued rent balance before the rent concession as part of the revised lease payments.

Sales-type/direct financing lease

A lessor would adjust the discount rate prospectively such that the net investment in the lease balance before the rent concession is the same as the net investment in the lease balance after the rent concession.

QUESTION 14.7

To what components does the COVID-19-related rent concession relief apply in a contract that has lease and nonlease components when a lessee or lessor elects not to account for the concession as a lease modification?

PwC response

We believe the relief provided to lessees and lessors by the FASB staff Q&A applies only to lease components that are accounted for under the new leases standard in a multiple component contract. See the following examples:

- Lessee: Assume a contract has a lease and a nonlease component. The lessee is accounting for the nonlease component separate from the lease component under other applicable GAAP. We believe the COVID-19-related rent concession should be allocated between the lease and nonlease components. The lessee can then elect to apply the relief to the lease component and should account for the nonlease component under other applicable GAAP.

- Lessor: Assume a contract has a lease component and a nonlease component. The nonlease component is the predominant component and if separated, would have been accounted for under the revenue standard. The lessor is accounting for the combined component under the revenue standard. We believe the relief for a COVID-19-related rent concession cannot be applied to the combined component since it is not being accounted for under the new leases standard. The lessor will therefore need to assess whether the concession is a modification of the price or scope (or both) of the customer contract under the revenue standard and if so, account for the modification in accordance with the revenue standard.

QUESTION 14.8 (added January 2021)

Is there an "end date" to the COVID-19-related rent concession relief in the FASB staff Q&A?

PwC response

No. There is no specific end date to the COVID-19-related rent concession in the FASB staff Q&A. We believe this relief will continue to apply to a rent concession that meets the criteria in the relief (i.e., the rent concession is COVID-19 related and the rights of the lessor or the obligations of the lessee are substantially the same before and after the rent concession).

QUESTION 14.9 (added January 2021)

Does the relief apply to new leases entered into during the COVID-19 pandemic and subsequently modified during the pandemic?

PwC response

The FASB staff Q&A does not specify that a lease must pre-date the COVID-19 pandemic to qualify for the relief. We believe the relief applies to any rent concession that meets the criteria in the relief (i.e., the rent concession is COVID-19 related and the rights of the lessor or the obligations of the lessee are substantially the same before and after the rent concession).

QUESTION 14.10 (added January 2021)

How should the relief be applied to additional concessions inserted in a lease agreement in response to the COVID-19 pandemic pursuant to a contract modification ("rolling rent concessions")?

PwC response

In order to qualify for the relief, a COVID-19-related rent concession should be such that the rights of the lessor or the obligations of the lessee are substantially the same before and after the rent concession. Additional lease concessions pursuant to a contract modification related to COVID-19 should be evaluated separately for purposes of this criterion unless they are negotiated as a package with other COVID-19-related lease concessions or their economics depend on the economics of other COVID-19-related lease concessions. In that case the additional COVID-19-related lease concessions pursuant to a contract modification should be evaluated together with other COVID-19-related lease concessions.

For example, assume a lessee and lessor modified a lease agreement in May 2020 and the lease concessions inserted due to COVID-19 qualified for the relief under the FASB staff Q&A. Due to the continuing COVID-19 pandemic, the lease was again modified in November 2020. The additional COVID-19-related lease concessions in November 2020 were negotiated on a standalone basis and not as a package with the May 2020 lease concessions. Also assume the November 2020 COVID-19-related lease concessions qualify for the relief if considered on a standalone basis because the rights of the lessor or the obligations of the lessee are substantially the same before and after the rent concessions. However, the May 2020 and November 2020 lease concessions in aggregate do not qualify for the relief because when considered together, the rights of the lessor or the obligations of the lessee are not substantially the same before and after the rent concessions.

In this example, we believe the November 2020 COVID-19-related lease concessions should be evaluated separate from the May 2020 COVID-19 lease concessions in evaluating eligibility for the relief due to the following:

- The applicability of the relief under the FASB staff Q&A has no expiration date.
- COVID-19 was prevalent in November 2020.
- The November 2020 COVID-19-related lease concessions were not negotiated as a package with the May 2020 COVID-19-related lease concessions.
- The economics of the November 2020 COVID-19-related lease concessions did not depend on the May 2020 COVID-19-related lease concessions.

QUESTION 14.11 (added January 2021)

If a COVID-19-related rent concession is negotiated in December 2020 but signed in January 2021 (i.e., the concession becomes legally enforceable in January 2021), can the COVID-19-related rent concession relief in the FASB staff Q&A be applied and accounted for in December 2020?

PwC response

No. We believe the COVID-19-related rent concession must be legally enforceable as of the balance sheet date in order to apply the relief in the FASB staff Q&A.

QUESTION 14.12 (added January 2021)

A lessee and lessor have an operating lease that has escalating fixed rents during the lease term. Due to the COVID-19 pandemic, the lease is modified such that all the fixed payments become variable payments. How should the lessor account for the existing deferred lease receivable balance due to straight lining of rents at the lease modification date?

PwC response

We believe the lessor should continue to reflect the existing deferred lease receivable balance (a deferred asset) on its books at the lease modification date and account for it as a lease incentive (i.e., amortize it on a straight-line basis over the remaining lease term).

QUESTION 14.13

Given the decrease in interest rates, should a company still evaluate lease classification and measure the lease liability using the incremental borrowing rate at the lease commencement date?

PwC response

Yes. Even though rates may have come down temporarily or may be uncertain due to the impact of COVID-19, ASC 842-20-30-1 still requires the use of the incremental borrowing rate at lease commencement date.

QUESTION 14.14

A capital lease (before adoption of ASC 842) contains a default covenant unrelated to the lease. The potential default payment was not included in the measurement of the capital lease because occurrence of the default was considered less than probable. What is the impact of activation of the force majeure provision due to COVID-19?

PwC response

Under ASC 840, a lease may have been classified as a capital lease due to a default covenant unrelated to the lease, such as a material adverse change provision. Further, the lessee may not have included the potential default payment in the measurement of the capital lease liability and asset because payment of that amount was considered less than probable.

If a force majeure provision is activated, the probability of paying the potential default amount may no longer be less than probable. In such an event, the lessee would need to accrue the full potential default amount in the capital lease liability and asset on that date.

Additional resources:

- PwC's *Leases* guide
- PwC's *Lessee right-of-use assets: 5 things you need to know* podcast
- In depth US2019-01: *FAQ: Lessee accounting for right-of-use assets in operating leases*

Loans

QUESTION 15.1

Assume that a lender modifies a loan with a borrower who is current on its loan and is experiencing short-term financial or operational matters as a result of COVID-19. The modification provides a deferral of interest payments for a three-month period and extends the maturity date of the loan by three months. During the interest deferral period, the loan will not accrue interest. The borrower has the ability to repay the loan at any time at an amount equal to principal plus accrued interest. Assuming that this modification would not be considered a troubled debt restructuring, the loan was not required to be placed on nonaccrual status, and that the amendment would be accounted for as a modification of a loan, how should the lender record interest income on the loan?

PwC response

At the FASB meeting on April 8, the FASB staff noted that they had received a technical inquiry relating to a similar fact pattern. The FASB staff noted that they believe there are two acceptable views under GAAP. Under one view, the lender would determine a new effective yield on the loan based on the current amortized cost basis and the revised contractual cash flows. This effective yield would be used to calculate interest income even if this could result in the carrying amount of the loan (including accrued interest) exceeding the amount the borrower could prepay. Alternatively, lenders could limit interest income during the interest deferral period as a result of the borrower's ability to repay the loan at the principal amount plus the amount of interest that has legally accrued.

Municipal bond disclosures

Many essential public services are furnished by governments and not-for-profit organizations (NFPs) that obtain capital through the municipal securities market.

In connection with issuing bonds in public offerings, these entities must agree to provide continuing disclosures to the municipal market regarding financial information, operating data, and events that may have a material impact on bond repayment. Those disclosures are filed with the Municipal Securities Rulemaking Board through its Electronic Municipal Market Access system (EMMA), which makes the information available to the investing public online and free of charge. In some cases, these entities may be unable to meet their continuing disclosure filing deadlines due to disruptions caused by the COVID-19 pandemic.

QUESTION 16.1

Does the SEC's March 25 order providing registrants an additional 45 days to file certain disclosure reports that would otherwise have been due between March 1 and July 1, 2020 apply to entities that file on EMMA pursuant to Exchange Act Rule 15c2-12?

PwC response

No. The SEC does not have direct regulatory authority over municipal securities offerings. Instead, indirect regulation is accomplished through requirements imposed by Rule 15c2-12, *Municipal Securities Disclosure,* on underwriters of these offerings. One such requirement is to ensure that the issuer (or in the case of NFPs, a conduit bond obligor) has entered into an agreement to implement a system of continuing disclosure that remains in effect as long as the bonds are outstanding.

Thus, continuing disclosure filing deadlines are not set by the SEC, but instead are generally established pursuant to a Continuing Disclosure Agreement (CDA) negotiated between the underwriter and the issuer or obligor. Due to the contractual nature of the continuing disclosure obligation, the SEC does not have the ability to extend filing deadlines or provide other relief directly to issuers in municipal securities markets.

QUESTION 16.2

What happens if a municipal bond issuer or conduit obligor is unable to meet a continuing disclosure deadline due to disruptions caused by COVID-19?

PwC response

As there are several types of continuing disclosure, it depends on the nature of the filing associated with the missed deadline.

One component of continuing disclosure involves providing certain financial information and operating data at least annually by a due date agreed upon by the parties (for example, 180 days after year end). In some industries (healthcare, for example), issuers and obligors may also agree to provide quarterly information on or before agreed-upon deadlines. If an entity will be unable to file this annual or quarterly information by the agreed-upon deadline in its CDA, Rule 15c2-12 requires that it provide timely notice on EMMA of its failure to file the information, and then make the required filing as soon as possible.

Another component of continuing disclosure is a requirement to disclose the occurrence of specific events enumerated within Rule 15c2-12 within 10 business days. If an entity will be unable to timely file an event notice, it should make that filing as soon as possible.

Entities should be aware, however, that while the SEC does not have direct regulatory authority over the municipal securities market, it can (and does) bring enforcement actions against issuers and conduit obligors that are found to have violated the antifraud provisions of the federal securities laws.

That said, the failure to comply with a CDA (such as missing a filing deadline) does not itself constitute a violation of those laws. However, Rule 15c2-12 requires that an official statement issued in connection with a new bond issue must disclose any instances within the prior 5 years in which the entity failed to comply, in all material respects, with its previous CDA undertakings.

If disclosure of a failure to comply is not made and is subsequently determined to be a material omission, it is a violation of the antifraud provisions that is subject to enforcement action by the SEC.

Non-GAAP measures

QUESTION 17.1

What guidance has the SEC staff issued on non-GAAP financial measures relating to COVID-19?

PwC response

In late March, the staff of the Division of Corporation Finance issued CF Disclosure Guidance: Topic No. 9 (Coronavirus (Covid-19)). This guidance provided several reminders regarding non-GAAP financial measures. It also addressed how to apply the SEC's requirements to reconcile a non-GAAP measure to the most directly comparable GAAP measure if a company presents preliminary results based on provisional amounts or ranges in an earnings release because of unknown factors relating to COVID-19.

This guidance indicates that in these situations, the staff will not object to companies reconciling a non-GAAP financial measure to preliminary GAAP results that include provisional amounts or a range of reasonably estimable amounts. The staff indicated that the provisional amounts or ranges should reflect a reasonable estimate of COVID-19-related items not yet finalized, such as impairment charges. Additionally, the staff indicated that if a company chooses to present its results in reliance on this guidance, it should limit the measures in its presentation to those non-GAAP financial measures it is using to report financial results to the Board of Directors.

It is important to note that this reconciliation guidance is applicable only to earning releases. In filings in which GAAP financial statements are required, such as filings on Form 10-K or Form 10-Q, companies should reconcile to GAAP results and not include provisional amounts or a range of estimated results.

QUESTION 17.2

How should a company identify the adjustments that are attributable to COVID-19?

PwC response

The SEC has not published guidance in this area that is specific to COVID-19. Just as with all non-GAAP financial measures, the identification of the adjustments that are attributable to COVID-19 will require judgment based on the particular facts and circumstances. Some things to consider when evaluating non-GAAP adjustments relating to COVID-19 include:

- **Attributable** – Is the adjustment clearly attributable to COVID-19? Would the item have been incurred absent COVID-19? Is it expected to continue after the pandemic is over?
- **Incremental** – Is the amount incremental to normal operations?
- **Actual** – Is the adjustment based on actual amounts (vs. hypothetical costs or lost opportunities)? For example, we understand the SEC staff would generally not view it as appropriate to prepare a non-GAAP measure that adjusts for lost revenue because of closing an operation or facility (see Question 17.4 regarding MD&A disclosures). Adjustments for incremental pay – what some are referring to as "combat pay" – may be appropriate, depending on the circumstances.
- **Quantifiable** – Are the adjustments sufficiently defined to allow reasonable quantification?

QUESTION 17.3

What are some items to consider when preparing and presenting a non-GAAP financial measure that has adjustments relating to COVID-19?

PwC response

It is important to note that there have been no changes to Item 10(e) of Regulation S-K, Regulation G, or the related Staff Compliance & Disclosure Interpretations (C&DIs) because of COVID-19. Those rules and the related guidance should be considered when evaluating any non-GAAP measures, including those relating to COVID-19.

While not an exhaustive list, some items to consider when preparing and presenting non-GAAP information that has adjustments relating to COVID-19 include:

- **Not misleading** – Non-GAAP information should not be presented in a manner that would be viewed as misleading in the context in which it is presented. While compliance with the rules and guidance referred to above is critical, the SEC staff has reminded companies in its C&DIs that non-GAAP information can be in technical compliance with the various regulations but still be considered misleading.
- **Prominence** – When a non-GAAP measure is being presented, Regulation S-K requires the most directly comparable GAAP measure to

be presented with equal or greater prominence. The staff's C&DIs on non-GAAP measures list certain examples of when the staff would consider a non-GAAP measure to be presented with more prominence, including:

  - a non-GAAP measure that precedes the most directly comparable GAAP measure (including in an earnings release headline or caption) and
  - presenting a full income statement of non-GAAP measures or presenting a full non-GAAP income statement when reconciling non-GAAP measures to the most directly comparable GAAP measures.

- **Disclosure** – Robust disclosure relating to the adjustments attributable to COVID-19 will be important.
  - A reader should be able to understand the objective of presenting a non-GAAP financial measure that reflects adjustments for COVID-19 and what the measure is intended to convey. The staff has stated that it would be appropriate to explain why management considers the measure useful and how the measure is useful to investors' understanding of the impact of COVID-19 on the company's financial statements.
  - If management is using the non-GAAP financial measure (e.g., to operate or evaluate the business) the disclosure should address how it is being used (to the extent material).
  - The disclosure should clearly identify the nature of the items that are being adjusted. For example, an adjustment relating to COVID-19 could represent a number of different items, such as goodwill impairment, inventory write offs, etc. The disclosure should provide transparency regarding the various items.
  - If a company is reconciling a non-GAAP measure to a GAAP measure that includes provisional amounts or an estimated range of GAAP measures in an earnings release, the SEC staff has indicated that the company should disclose the reason the accounting is incomplete and what additional information or analysis may be needed to complete the accounting (to the extent practicable).
- **Controls** – The company should consider its controls and procedures surrounding the presentation of non-GAAP measures, including those with adjustments relating to COVID-19. These controls would typically include appropriate governance practices and policies to, among other things, prevent error or manipulation and address matters relating to consistency in identifying the adjustments and how the adjustments are being described.
- **Consistency** – The SEC staff stated in its C&DIs relating to non-GAAP measures that a non-GAAP measure can be misleading if it is presented inconsistently between periods. The company should consider whether there is consistency between periods in the adjustments that are being attributed to COVID-19. If a company does make a change, they should consider disclosing that fact, and whether to recast the non-GAAP measures for prior periods. Additionally, if a company presents adjustments for COVID-19 that add back expenses and charges, it

should also evaluate the SEC staff's guidance relating to the need to consider appropriate adjustments for income or credits (e.g., non-recurring grants or subsidies).

- **Income taxes** – Consistent with the SEC staff's existing guidance, the gross amount of adjustments should be presented separately from tax effects. The CARES Act contains various provisions that could affect the company's tax provision. Consideration should be given to separately disclosing the amount attributable to the tax effect of the various adjustments and the effect of changes in the tax law.

QUESTION 17.4

How can a company communicate the effects of COVID-19 if an adjustment is not included in the non-GAAP presentation?

PwC response

Non-GAAP information can assist in explaining the effects of COVID-19 on the financial statements, however, non-GAAP measures, on their own, might not be sufficient to describe the totality of the effect. Companies will be able to address such matters in Management's Discussion and Analysis (MD&A).

To illustrate, assume a retail company has temporarily closed all of its stores as a result of COVID-19. The company could address the impact in MD&A through a discussion of items such as lost in-store sales, changes in online purchases, changes to employee costs, government assistance, etc. The MD&A allows for a comprehensive discussion.

Another example relates to impairment charges. Companies that record impairment charges for goodwill or other assets attributable to declining performance related to COVID-19 might present non-GAAP measures that exclude these charges. While such measures can be useful in explaining the results for the period, they may only tell part of the story: that there was a charge relating to COVID-19 and the results would have been different absent the charge. Companies can use MD&A to provide additional disclosure to explain the impact COVID-19 has on projections that resulted in the impairment charge. SEC Chairman, Jay Clayton, and Division of Corporation Finance Director, William Hinman, issued a Public Statement on April 8, 2020, which stresses the importance of discussing forward looking information.

Pensions

QUESTION 18.1

If a company needs to remeasure its pension and postretirement benefit plans, what are some of the key considerations the company should focus on in the current environment?

PwC response

Upon remeasurement, all actuarial, and financial, and demographic assumptions are evaluated and updated, and a new determination of the plans' projected benefit obligation and asset values is made using current market values and assumptions. With potentially significant changes in headcount and human capital plans and programs, coupled with the volatility in the market for plan assets and interest rates, companies should carefully evaluate significant assumptions and the methods used to determine them in the current period. Certain approaches may need to be refined in the current period to ensure they reasonably reflect actual results. For example, a company that historically rolls forward certain participant census data from an earlier date to the measurement date, as might be contemplated in ASC 715-30-35-64, might need to further evaluate the impact of restructuring actions or changes in employee behavior or elections on such data. Similarly, credit downgrades of corporate bond issuers that were previously rated "high quality" may impact the population of bonds historically utilized to determine the discount rate for a company's pension and postretirement benefit plans.

Additional resources:
• PwC's *Pension and employee benefits* guide, Chapter 2

Revenue

QUESTION 19.1

How could disruptions that impact either the company's or a customer's ability to meet performance targets impact revenue recognition?

PwC response

The potential disruption to supply chains or the "normal course of business," upon which many estimates of variable consideration may have originally been based, will likely necessitate a reassessment of variable consideration in a variety of contexts. Under ASC 606, *Revenue from Contracts with Customers*, management determines the total transaction price, including an estimate of any variable consideration, at contract inception and reassesses this estimate at each reporting date. Variable consideration is included in the transaction price only to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved. The transaction price is recognized as revenue when, or as, the related performance obligation is satisfied.

Variable consideration takes many forms, including volume discounts, rebates, returns, refunds, and royalties. Consideration is also variable if it is contingent on a future event occurring or not occurring, such as meeting performance goals (early completion bonus or commercialization milestone) or failing to meet a contractual deadline (liquidated damages), or a customer achieving a certain outcome, such as a distributor meeting a target level of gross margin upon resale. Estimates of variable consideration are subject to change as facts and circumstances evolve. Management should revise its estimates of variable consideration at each reporting date throughout the contract period. Any changes in the transaction price would be allocated to all performance obligations in the contract unless the variable consideration relates only to one or more, but not all, of the performance obligations.

QUESTION 19.2

How could revenue recognition be impacted by a customer's inability to make payments due to the disruption caused by the coronavirus or other economic events?

PwC response

ASC 606 requires that in order to have a "contract" and, therefore, to be able to recognize revenue, a company must conclude that it is probable it will collect substantially all of the consideration to which it will be entitled under the arrangement. If a company continues to sell products and services to a customer when it is uncertain whether collection is probable—due to the potential deterioration of its customer's financial position or that customer's current inability to settle outstanding receivables—the question arises as to whether revenue can continue to be recognized on new transactions.

ASC 606 requires a company to first consider any potential price concessions that it expects to provide, which reduce the transaction price, before assessing collectibility. Additionally, a company should consider as part of the collectibility assessment whether it has the ability and intent to cease providing service if the customer fails to pay. In many cases it may be challenging to conclude that collection for new sales is probable when the customer has been unable to pay existing receivables. This type of situation requires judgment and is dependent upon facts and circumstances; however, if a company cannot conclude collection is probable at inception of an arrangement, it cannot recognize revenue from the arrangement.

If a company concludes collection is not probable at contract inception, it should continue to reassess this conclusion each reporting period as collection may become probable at a later date. Further, even for contracts that are currently in process, a significant change in facts and circumstances, such as a significant deterioration in a customer's ability to pay, would be an indicator that a company should also reassess whether it is probable that it will collect the remaining consideration under the contract for future goods and services.

If a company concludes collection is not probable, but the customer subsequently makes a payment, revenue can only be recognized when one or more of the following occurs:

Excerpt from ASC 606-10-25-7

a. The entity has no remaining obligations to transfer goods or services to the customer, and all, or substantially all, of the consideration promised by the customer has been received by the entity and is nonrefundable.

b. The contract has been terminated, and the consideration received from the customer is nonrefundable.

c. The entity has transferred control of the goods or services to which the consideration that has been received relates, the entity has stopped transferring goods or services to the customer (if applicable) and has no obligation under the contract to transfer additional goods or services, and the consideration received from the customer is nonrefundable."

QUESTION 19.3

How should a company account for "customer goodwill" gestures, such as giving customers free or discounted goods or services, price concessions, or extended payment terms?

PwC response

A company that provides free or discounted goods to existing customers should first consider whether the transaction (a) should be combined with another revenue transaction entered into at or near the same time based on the criteria in ASC 606-10-25-9 or (b) changes the scope of an existing customer contract and should be accounted for as a modification (see Question 19.4).

An option to receive free or discounted goods or services that is combined with another revenue transaction may provide a material right to the customer. Material rights are a separate performance obligation in the contract and a portion of the transaction price (consideration) should be allocated to the right based on the relative standalone selling price allocation framework. However, if the company is offering the goods or services at the same price to similar customers on a standalone basis (i.e., without entering into a current revenue transaction), it would be considered a marketing offer rather than a material right and would have no accounting impact at the time it is offered.

If a company gives customers or potential customers free goods or services that are not provided in connection with another revenue transaction, it would likely conclude a contract does not exist because there are no enforceable rights and obligations. Accordingly, no revenue would be recognized as the free goods or services are transferred. Revenue would generally be recognized on a prospective basis if the customer subsequently commits to purchase additional goods or services from the company. That is, revenue would not be allocated to the goods or services that were transferred for no consideration before a contract existed in that circumstance.

Companies may decide to offer price concessions to customers related to past, ongoing, or future transactions. If a company expects to provide a price concession to a customer related to a new contract, the transaction price (and revenue recognized) should be reduced by the amount of the expected concession. In that case, the expected price concession is variable consideration that is estimated and updated each reporting period. If a company does not intend to provide a price concession at contract inception, transfers control of goods or services, and recognizes revenue (assuming collection was assessed as probable at contract inception), the resulting receivable or contract asset is subject to the guidance in ASC 310, *Receivables,* (or ASC 326, *Financial Instruments—Credit Losses*, when adopted). Accordingly, changes in the customer's ability or intent to pay would be reflected in bad debt expense or credit losses. If the company decides to offer a price concession to a customer subsequent to contract inception, judgment may be required to assess whether the concession is a modification of a receivable, credit loss, or a modification of an existing revenue contract (see Question 19.4).

As a result of current events, a company may decide to offer payment terms to customers that extend longer than typically offered. For a new contract, extended payment terms should be considered in the assessment of whether collection is probable and/or whether the company intends to provide a concession at contract inception (see Question 19.2). Extended payment terms may also indicate that the arrangement includes a significant financing component. Importantly, the mere existence of extended payment terms is not determinative when assessing whether collection is probable (for purposes of establishing the existence of a contract) and all facts and circumstances should be evaluated. Companies should also consider whether extended payment terms affect their assessment of the allowance for doubtful accounts or credit losses (see Question 6.5). If a company modifies an existing contract to extend payment terms (potentially changing the transaction price), it should consider whether the contract modification guidance applies, particularly if the change is made in conjunction with other changes to the scope of the contract (see Question 19.4).

QUESTION 19.4

What is the impact of modifying a revenue contract to provide future concessions, such as reducing the price or decreasing quantities of goods or services to be delivered (or minimum purchase commitments)?

PwC response

A modification is accounted for as a separate contract only if distinct goods or services are added to the contract for a price equal to standalone selling price (adjusted for contract-specific circumstances). The accounting for a modification that is not a separate contract depends on whether the remaining goods or services are distinct from the goods or services transferred before the modification:

- If the remaining goods or services are not distinct (e.g., a single performance obligation is being modified), the modification is accounted for on a cumulative catch-up basis. Estimates of the transaction price and measure of progress are updated and cumulative revenue recognized is adjusted (increased or decreased) accordingly.
- If the remaining goods or services are distinct (including goods or services that are part of a series), the modification is accounted for prospectively as if it were a termination of the existing contract and the creation of a new contract. The sum of: (a) unrecognized consideration from the original contract and (b) additional consideration promised as part of the modification is allocated to the remaining goods or services to be provided based on relative standalone selling prices as of the modification date.

For modifications accounted for on a prospective basis, price concessions given due to current events (as opposed to concessions related to the company's past performance) will generally reduce the consideration allocated to the remaining goods or services and accordingly, reduce revenue recognized for future goods or services. Judgment may be required to determine whether a decision to give away free or highly discounted goods or services is a modification of an existing customer contract or a marketing offer that does not impact the accounting for existing contracts.

QUESTION 19.5

If a company's customary business practice is to obtain written, signed contracts, does an enforceable contract exist if a written contract is not obtained (e.g., approvals received via e-mails, product shipped without a contract)?

PwC response

It depends. The fact that the company normally obtains written contracts does not necessarily mean that other forms of agreements (e.g., oral or electronic) do not meet the definition of a contract. The company needs to determine if the agreement creates legally enforceable rights and obligations, which might be achieved through forms other than a written contract. Legal enforceability depends on the interpretation of the law and could vary across legal jurisdictions.

QUESTION 19.6

How is revenue recognition impacted if delivery of a product cannot be completed, for example due to shipping restrictions or closure of a customer's facility preventing physical delivery?

PwC response

Although revenue recognition often coincides with delivery of a product, timing of revenue is not necessarily based on delivery, but is instead based on transfer of control to the customer. In some cases, revenue may be recognized over time such that all or most of the revenue is recognized prior to delivery. For example, revenue for customized products might be recognized over time as the products are manufactured if the company has the right to payment for performance to date. If revenue is recognized (i.e., control transfers) at a point in time, the guidance provides five indicators that help to identify the point at which control has transferred:

(1) the entity has present right to payment

(2) the customer has legal title to the asset

(3) the entity has transferred physical possession of the asset

(4) the customer has the significant risks and rewards of ownership

(5) the customer has accepted the asset

The indicators are not intended to be used as a checklist nor do all indicators need to be met in order to conclude that control has transferred. Significant judgment may be required to determine whether control has transferred if only some of the indicators have been met.

In certain circumstances, control transfers to the customer at a point in time before the customer has physical possession. This most commonly occurs in arrangements when title and risk of loss passes to the customer upon transfer to a third-party shipper and as a result, the company concludes control transfers at shipping point. It may also occur in connection with a bill-and-hold arrangement when the parties agree that the seller will retain physical possession of the products and transfer them to the customer at some point in the future. In addition to considering the indicators of point in time control transfer, the following criteria in ASC 606-10-55-83 must be met to conclude a customer has obtained control in a bill-and-hold arrangement:

Excerpt from ASC 606-10-55-83

a. The reason for the bill-and-hold arrangement must be substantive (for example, the customer has requested the arrangement).

b. The product must be identified separately as belonging to the customer.

c. The product currently must be ready for physical transfer to the customer.

d. The entity cannot have the ability to use the product or to direct it to another customer.

If control has transferred in a bill-and-hold arrangement, a company should also consider whether it has remaining performance obligations, such as custodial or delivery services. If so, a portion of the transaction price should be allocated to those performance obligations and recognized as they are satisfied.

QUESTION 19.7

How is revenue recognition impacted if a company expects to receive an increased volume of returns or relaxes return criteria as a customer accommodation?

PwC response

When control has transferred, but customers have an explicit or implicit right to return products, the amount of revenue recognized is reduced by estimated returns. The company recognizes a corresponding refund liability for the consideration to be returned to the customer and an asset for its right to the product(s) to be recovered from the customer. The reduction of revenue for expected returns is a form of variable consideration; accordingly, the estimate of returns and related assets and liabilities should be updated each period. The variable consideration constraint also applies, which states that revenue should only be recognized to the extent it is probable that a significant reversal in cumulative revenue recognized will not occur in the future.

While estimated returns are often based on historical experience, companies should consider any expected changes in customer behavior resulting from the current economic environment in their estimates of returns. Additionally, companies should consider whether the estimate is impacted by business practices or communications to customers outside of the contract, such as a willingness to take returns outside of the stated return period. The guidance also requires several disclosures that may be relevant, such as (a) information about obligations for returns or refunds, (b) significant judgments in determining the transaction price, including estimates of variable consideration and application of the constraint, and (c) changes in transaction price for previously satisfied performance obligations (for example, as a result of changes in estimates of variable consideration).

Additional resources:

- PwC's *Revenue from contracts with customers* guide
- PwC's *COVID-19: Revenue contract modification questions*, answered podcast

Sales of held-to-maturity securities

QUESTION 20.1

What are the accounting implications if a company sells securities that are classified as held to maturity?

PwC response

Other than the specific circumstances described in ASC 320-10-25-6, ASC 320-10-25-14, and ASC 320-10-25-18, a company cannot periodically sell or transfer investments from the held-to-maturity category without calling into question the company's:

- previous assertions regarding the classification of those securities,
- assertions regarding the classification of other held-to-maturity securities, and
- future assertions regarding the classification of securities until the company has reestablished the credibility of its classification policy.

Because a company's assertions relate to each investment in the held-to-maturity category, the sale of individual held-to-maturity securities will call into question a company's intent to hold all securities in the held-to-maturity category. The held-to-maturity category is purposely restrictive such that the use of amortized cost must be justified for each investment.

If a sale or transfer of a debt security results in a tainting event, all remaining held-to-maturity securities should be reclassified to available for sale. Securities should not be classified as held to maturity for some period of time following the tainting of the portfolio. This tainting period is intended as time for the company to reestablish its policies and procedures to ensure that it has both the intent and ability to hold securities to maturity. It also allows the company to demonstrate its reestablished intent and ability to hold securities to maturity. Practice has generally considered the taint period for sales or transfers of held-to-maturity securities that do not meet the limited exceptions in ASC 320 to be approximately two years.

Under ASC 320-10-25-6, the sale of a security that was classified as held to maturity may not taint a company's assertion that other securities are held to maturity if the change in management's intent was due to one of the following changes in circumstances:

Excerpt from ASC 320-10-25-6

a. Evidence of a significant deterioration in the issuer's creditworthiness (for example, a downgrading of an issuer's published credit rating)

b. A change in tax law that eliminates or reduces the tax-exempt status of interest on the debt security (but not a change in tax law that revises the marginal tax rates applicable to interest income)

c. A major business combination or major disposition (such as sale of a component of an entity) that necessitates the sale or transfer of held-to-maturity securities to maintain the entity's existing interest rate risk position or credit risk policy

d. A change in statutory or regulatory requirements significantly modifying either what constitutes a permissible investment or the maximum level of investments in certain kinds of securities, thereby causing an entity to dispose of a held-to-maturity security

e. A significant increase by the regulator in the industry's capital requirements that causes the entity to downsize by selling held-to-maturity securities

f. A significant increase in the risk weights of debt securities used for regulatory risk-based capital purposes.

Additional resources:

- PwC's *Loans and investments* guide

Subsequent events

QUESTION 21.1

How should a company consider whether events subsequent to the balance sheet date but prior to issuance of the financial statements should be reflected in the financial statements?

PwC response

As described in ASC 855-10-20, there are two types of subsequent events:

- Events or transactions that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements (recognized subsequent events)
- Events that provide evidence about conditions that did not exist at the date of the balance sheet but arose subsequent to that date (nonrecognized subsequent events).

Recognized subsequent events are recorded in the financial statements to be issued. Examples include the realization of a loss on the sale of inventory or property held for sale when the subsequent act of sale confirms a previously existing unrecognized loss. Changes in lower of cost or net realizable value considerations related to inventory valuation in the subsequent period may also be recognized subsequent events (see Question 21.2).

Nonrecognized subsequent events generally do not relate to conditions existing at the balance sheet date and so they are not recognized in the financial statements. However, disclosure may be necessary based on the nature of the event to keep the financial statements from being misleading. Changes in the fair value of assets or liabilities (financial or nonfinancial) after the balance sheet date are generally nonrecognized subsequent events, but they may warrant disclosure.

Determining whether an event is recognized or unrecognized can be more difficult when circumstances are evolving versus evaluating a single isolated event. When events develop over a period of time, some portions of the impact may be recognized, while other portions are unrecognized.

Because ASC 855 does not provide an explicit threshold for determining which subsequent events require disclosure, the decision regarding when to disclose a subsequent event is based on specific facts and circumstances, including materiality, and requires judgment. Generally, a subsequent event should be disclosed if it meets both of the following criteria:

- The event should have a determinable (even if not yet definitively quantified) significant effect on the balance sheet at the time of occurrence or on the future operations of the company.
- Without disclosure of it, the financial statements would be misleading.

ASC 855 does not require a company to include all subsequent event disclosures in a single footnote. Rather, management may determine where to include the disclosures in the context of the financial statements.

QUESTION 21.2

If sales are significantly reduced or suspended for an extended period subsequent to the balance sheet date, how should companies assess the impact to inventory valuation?

PwC response

Under ASC 855-10-55-1(b): "Subsequent events affecting the realization of assets, such as inventories, or the settlement of estimated liabilities, should be recognized in the financial statements when those events represent the culmination of conditions that existed over a relatively long period of time."

Companies will need to assess the timing of the coronavirus-related events that impact inventory valuation. All information related to inventory valuation should be taken into account through the issuance of the financial statements (or when available to be issued for private companies). However, when a specific event results in the loss of value of the inventory, such as discrete decisions to close stores or governmental actions to restrict individuals' activities that may not have been reasonably predicted as of the balance sheet date, the inventory would be impaired in the same period that the specific event occurred.

Sales of inventory or other events after the balance sheet date may provide additional evidence about conditions that existed at the balance sheet date that could impact a company's valuation of inventory at the lower of cost or net realizable value. Determining the net realizable value at the balance sheet date is a matter of judgment. A company should consider all data available, including future demand and subsequent changes in product prices that may provide additional information about the valuation at the balance sheet date.

Additional resources:

- PwC's *Financial statement presentation* guide, Chapter 28
- PwC's *Subsequent events, what you need to know* podcast

Taxes

QUESTION 22.1 (updated January 2021)

What should a company consider when assessing the need for a valuation allowance in the current environment?

PwC response

Companies must reassess the need for a valuation allowance on deferred tax assets at each reporting date.

ASC 740-10-30-17 indicates that all available evidence should be considered when assessing the need for a valuation allowance. "All available evidence" includes historical information supplemented by all currently available information about future years. Events occurring subsequent to a company's period-end, but before the financial statements are released, that provide additional evidence regarding the likelihood of realization of existing deferred tax assets should also be considered when determining whether a valuation allowance is needed.

ASC 740-10-30-21 indicates that it is difficult to avoid a valuation allowance when there is negative evidence such as cumulative losses in recent years. Losses expected in early future years and uncertainties whose unfavorable resolution would adversely affect future results are also negative evidence to be considered. Even if there has been income in recent years, companies need to consider projections of near-term future losses, including if they will result in a cumulative loss position.

Generally, a company's most recent results are the most objectively verifiable indicator of its future performance. This is why a cumulative loss is such a significant piece of negative evidence to overcome. Many companies rely on forecasts of taxable income exclusive of reversing temporary differences to support realization of some or all their deferred tax assets. Forecasts are inherently less objective than prior results, so if a company has a cumulative loss, then its forecast must reach the level of objectively verifiable in order to overcome the historical results. Often companies may use their most recent year's results as a baseline for its forecast of taxable income, adjusting it for items that are objectively verifiable (e.g., items that have already occurred, like the pay down of debt or the acquisition of a business late in the prior year). However, in the current environment, it may be harder to gauge whether the most recent results are indicative of future performance given the impact of the pandemic (negative or positive) on prior year results. This area will require significant judgment, and consideration of all available evidence as the impact of the pandemic unfolds.

QUESTION 22.2 (updated January 2021)

How should a company estimate its annual effective tax rate if it is unsure how the current economic environment will impact operations?

PwC response

At each interim period, a company is required to estimate its forecasted full-year annual effective tax rate (AETR). That rate is applied to year-to-date ordinary income or loss in order to compute the year-to-date income tax provision. In order to compute the AETR, a company needs to estimate its full year ordinary income and its total tax provision, including both current and deferred taxes. When a company is subject to tax in multiple jurisdictions, one overall (i.e., worldwide) estimated AETR is developed and applied to consolidated ordinary income (loss) for the year-to-date period.

Given the financial impact of recent events, it may be relevant for companies to consider ASC 740-270-30-18, which indicates that if a reliable estimate cannot be made, the actual effective tax rate for the year to date may be the best estimate of the annual effective tax rate. Two additional exceptions may also be relevant:

- When a company operates in a jurisdiction that has generated ordinary losses on a year-to-date basis, or anticipates an ordinary loss for the full fiscal year, and no benefit can be recognized on those losses, the company should exclude that jurisdiction's income (or loss) from the overall estimate of the AETR. In effect, any jurisdictions with losses for which no benefit can be recognized are removed from the base calculation of the AETR and a separate AETR is calculated for that jurisdiction.
- When a company cannot make a reliable estimate of ordinary income for a particular jurisdiction, that jurisdiction should be excluded from the overall computation of the estimated annual effective tax rate. Determining whether an estimate is reliable requires the use of professional judgment. For example, in some cases, a small change in an entity's estimated ordinary income could produce a significant change in the AETR. This might occur when a company that is anticipating only marginal pre-tax book profitability for the year has significant permanent differences that could result in wide variability in the tax expense (benefit) and, in turn, the AETR. In such cases, an estimate of the AETR would not be reliable if a small change in ordinary income were likely to occur. While there is a general presumption that entities will be able to make a reliable estimate of ordinary income, exceptional circumstances can exist

in which a genuine inability to make a reliable estimate justifies exclusion of a jurisdiction from the worldwide effective tax rate. A company's assertion that it cannot develop a reliable estimate should be consistent with its other disclosures and communications to its investors, creditors, and other financial statement users.

QUESTION 22.3

When should a company account for the impacts of tax legislation?

PwC response

Under US GAAP, the effect of a change in tax law is recorded discretely as a component of the income tax provision related to continuing operations in the period of enactment.

If a change in tax law is enacted after a company's balance sheet date, the change is not reflected until the period that includes the enactment date. This is true even if the enacted law change is retroactive to a date prior to enactment. Companies should consider disclosing the potential impact of any material change in tax law that is enacted after the balance sheet date but before the financial statements are issued.

The enactment date of a change in tax law is not always straightforward. We believe that "enactment" occurs when the law has been subjected to the full legislative process. Since the effect of a change in tax law is recognized in the financial statements when the law is enacted, it is important to understand when the full legislative process is completed in the jurisdiction of the tax law change. For US federal tax purposes, most states, and many foreign jurisdictions, the enactment date is most often the date an official, such as the President, signs the legislation into law.

QUESTION 22.4

What should companies consider with respect to indefinite reinvestment assertions on undistributed foreign earnings in the current environment?

PwC response

Companies asserting indefinite reinvestment of outside basis differences in one or more foreign subsidiaries should continue to assess how current economic conditions might affect the company's cash needs and its ability to continue to assert indefinite reinvestment (and thereby avoid recording a related tax liability). For example, companies that have upcoming debt service requirements or that have failed (or are in danger of failing) a covenant should consider whether they continue to have the ability to control the timing of the remittance of foreign earnings (i.e., whether a remittance would be required if the debt were called). Consideration should be given to the company's ability to manage its borrowing needs, including access to existing credit facilities.

A question may arise as to whether a "one-time" repatriation of cash in response to current economic conditions would "taint" a company's indefinite reinvestment assertion. The answer depends on the specific facts and circumstances of each company. Considerations may include which earnings are being repatriated (i.e., current earnings vs. historical earnings), from which subsidiaries, the tax law applicable to the repatriation, and the business rationale for the change, among others.

The potential tax liability related to outside basis differences in foreign subsidiaries may not be as significant as it was before the Tax Cuts and Jobs Act of 2017, and foreign earnings may be remitted in a tax-free manner in many jurisdictions (including the US) as a result of a participation exemption or a dividend received deduction. However, companies that are unable to assert indefinite reinvestment may still need to record deferred taxes for items such as withholding taxes, foreign currency impacts, and state and local taxes.

In most cases, the initial recognition of a deferred tax liability for the temporary difference accumulated in prior periods as a result of a change in the indefinite reversal assertion will be reflected entirely in continuing operations. Intraperiod allocation should be considered for any adjustments to the deferred tax liability resulting from current-year movements in the temporary difference. Unrealized foreign currency gains and losses associated with the subsidiary's net assets, including unremitted earnings, represent translation gains and losses that are reported as part of other comprehensive income (OCI). Therefore, the deferred tax effect of the translation gains and losses would also be recorded through OCI.

If withholding taxes are accrued as part of the deferred tax liability, the treatment of future foreign currency movements will likely differ. The withholding tax is an obligation of the parent. Assuming a US parent with a withholding tax payable in a foreign currency, any change in the amount of the withholding tax liability caused by foreign currency exchange rate changes is a transaction gain or loss, which is recorded through the income statement (either within tax expense or in pre-tax earnings, depending on the company's policy).

Additional resources:

- PwC's *Income taxes* guide
- PwC's *Valuation allowance for deferred tax assets – the basics* podcast
- In depth US2019-19, *FASB simplifies accounting for income taxes*
- PwC's *Income tax accounting year-end reminders* podcast

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