Hot Topic: Coronavirus

Subsequent events, going concern, unusual items and risks and uncertainties disclosures

March 25, 2020 (Updated June 24, 2020[1])

KPMG highlights potential effects of COVID-19 on financial statement disclosures.

Background

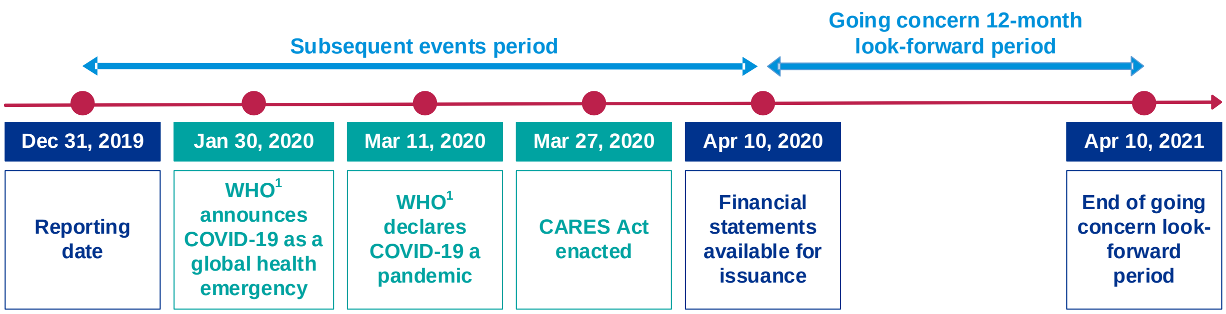
COVID-19 is having a significant impact on global markets driven by supply chain and production disruptions, workforce restrictions, travel restrictions, reduced consumer spending and sentiment, amongst other factors, which are negatively affecting companies' financial performance, liquidity and cash flow projections.

Financial statement users expect, and US GAAP requires, adequate disclosure of the current and potential effects of COVID-19 in the financial statements. This includes disclosures about subsequent events under Topic 855, the going concern assumption under Subtopic 205-40, unusual items under Subtopic 220-20, and risks and uncertainties under Topic 275. There are additional related filing disclosure requirements that apply to SEC issuers.

These disclosures are company-specific and often require judgment to identify what to disclose and when. Disclosure thresholds differ under each standard – e.g. disclosure of COVID-19 as a subsequent event and its effect on estimates may be necessary even though the going concern assumption is still valid. However, those disclosures are interrelated and should be approached holistically. Also, the effects of COVID-19 are far-reaching and rapidly evolving. Therefore, the later the December 31, 2019 financial statements are issued, the more pervasive and detailed these disclosures will be.

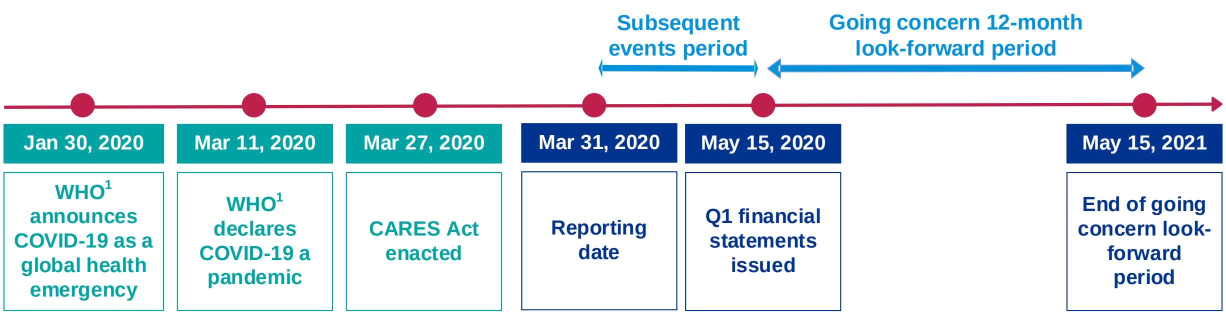
The following timeline illustrates how the chronology of COVID-19 events applies to a calendar year-end company issuing financial statements on April 10, 2020.

[1] New guidance or significant updates are indicated with **



Note 1: World Health Organization

**The following timeline illustrates how the chronology of COVID-19 events applies to a calendar year-end company issuing its first quarter interim financial statements on May 15, 2020.



Note 1: World Health Organization

Subsequent events

Topic 855 requirements

Events occurring after the balance sheet date but before the financial statements are issued (or available to be issued for non-SEC filers) require disclosure or possibly recognition.

	Definition	Financial statement effects
Recognized (Type 1) subsequent events	Provide additional evidence about conditions that existed as of the date of the balance sheet, including estimates inherent in financial reporting. Subsequent events affecting the realization of assets (e.g. receivables or inventories) or the settlement of expected liabilities are recognized if they represent the culmination of conditions that existed over a relatively long period of time. [855-10-25-1, 55-1(b)]	The financial statements are adjusted for any events or changes in estimates resulting from recognized subsequent events. [855-10-25-1]
Nonrecognized (Type 2) subsequent events	Provide evidence about conditions that did not exist at the date of the balance sheet, but arose after the balance sheet date but before financial statements are issued (available to be	The nature of the event, and an estimate of its financial effect, or a statement that such an estimate cannot be made, is disclosed if the

	issued). Examples include changes in fair value or foreign exchange rates after the balance sheet date. [855-10-25-3, 55-2]	financial statements would otherwise be misleading. [855-10-50-2]

Is COVID-19 a recognized or nonrecognized subsequent event?

The World Health Organization did not announce the coronavirus as a global health emergency until the end of January 2020, and no significant measures were taken by any governments until early 2020. Further, the effects of COVID-19 did not have a significant impact on global markets and share prices until February 2020.

For **December 31, 2019 financial statements** that have not yet been issued, financial reporting impacts will likely be limited to nonrecognized subsequent events that should be disclosed. For example, companies may experience losses due to supply chain disruptions or volatility in commodities markets that should be disclosed. A triggering event related specifically to COVID-19 for goodwill and long-lived asset impairment testing is also a nonrecognized subsequent event at December 31, 2019.

However, there may be existing conditions before December 31 that are further impacted by the outbreak, such that recognition in the financial statements for the year ended December 31, 2019 may be required. For example, a customer's bankruptcy after the reporting date is often the culmination of a sequence of events that started before that date (e.g. the US-China trade tension). In this scenario, the receipt of information about the bankruptcy may be a recognized subsequent event.

Later periods. For companies whose fiscal year is other than the calendar year, and calendar-year companies reporting quarterly in 2020, COVID-19 is a Q1 current period event that will require ongoing evaluation to determine the extent to which developments after the respective reporting date should be recognized in that reporting period. As COVID-19 caused a series of key events across the world, each company will need to evaluate the relevant facts and circumstances to conclude if these are recognized or nonrecognized subsequent events. Considering all available facts (e.g. infection rates, market prices) and the impact of such facts on management's estimates through the date the financial statements are issued (available to be issued) may present operational challenges and require judgement in complex estimate models, given the rapidly changing COVID-19 situation.

Our other Hot Topics available at read.kpmg.us/coronavirus discuss the application of this guidance to various issues, such as:

- goodwill and long-lived asset impairment testing and useful lives reassessment;
- expected credit losses under Topic 326;
- measurement of financial assets before Topic 326;
- inventory valuation;
- debt covenants; and
- CARES Act.

Subsequent events disclosure considerations

Companies need to separately assess the events that have occurred as a series of unfolding events related to COVID-19, rather than focus on a single event – e.g. China outbreak, world pandemic, local containment and government aid packages announcements. Each company may be affected differently by each event and should adapt its disclosures accordingly.

For example, a restaurant company operating predominantly in the United States may not have identified any notable impact of COVID-19 until sometime in March 2020 as a result of states' orders to close restaurants. In that scenario, we would expect management to identify states' lockdown orders as a relevant subsequent event to disclose, if the financial statements were not already issued at that point. In comparison, a car manufacturer operating a production line in Wuhan, China would likely identify Wuhan's January lockdown as a relevant subsequent event to disclose.

These disclosures do not need to be located in a single note. However, we believe they should be holistic. For example, it would not be appropriate for a company to disclose the potential upside effect of a government aid package without mentioning the potential downward effects of COVID-19 on debt covenants. In addition, the expected impact on the going concern assessment and disclosures of risks and uncertainties should be considered.

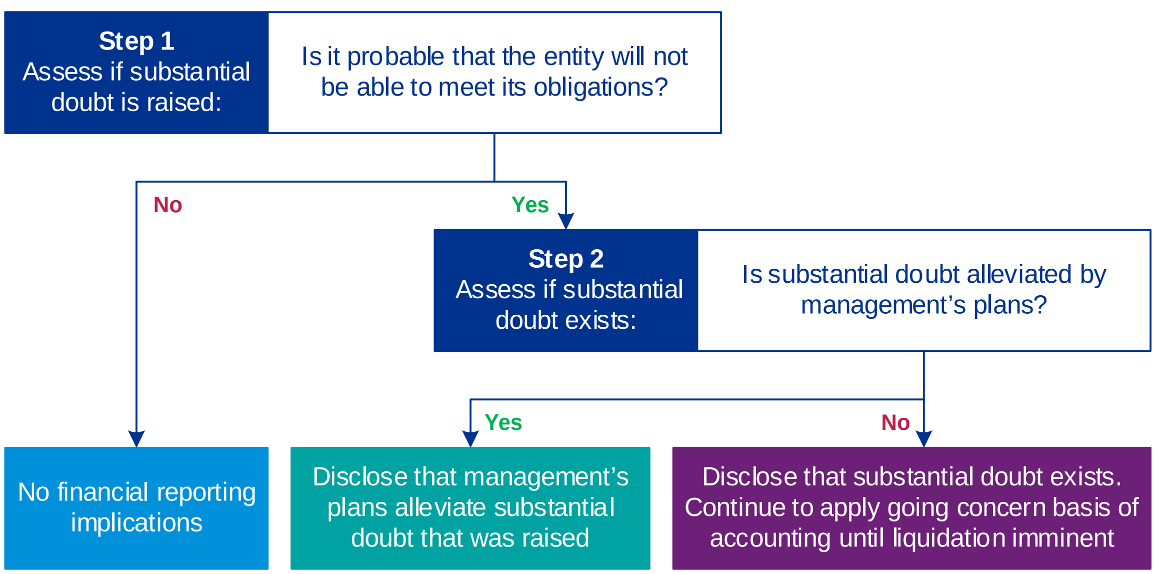
Quantitative disclosure of the estimated financial effect of the subsequent event(s) is required if it can be made. This estimate is to be based on the facts available at the date the financial statements are issued (available to be issued) and should avoid general forward looking statements. For example, it would not be appropriate to disclose that: "We expect the fair value of our investment to recover in the near future." But a company could say: "The fair value of our investment as of this date has dropped by xx% since [reporting date]. We are uncertain if those values will rebound in the near future."

Going concern

Subtopic 205-40 requirements

To be a going concern, a company must have the ability to meet its obligations as they come due within one year after the financial statements are issued (available to be issued) – i.e. the look-forward period. Management has a responsibility to determine whether there are conditions and events that raise 'substantial doubt' about the company's ability to continue as a going concern. [205-40-50-1]

The following diagram represents how this two-step assessment is conducted. [205-40-50-1]



See KPMG Handbook, Going concern, for an in-depth look at management's going concern assessment.

COVID-19 affects the going concern assessment

For many companies, a detailed going concern analysis may not have been necessary previously – historically profitable business, ready access to financial resources and no significant short-term obligations; however, these quantitative and qualitative factors may have changed as a result of COVID-19.

December 31, 2019 financial statements that have not yet been issued may require management to consider COVID-19 in their going concern evaluations. For companies whose fiscal year is other than the calendar year, and calendar-year companies reporting quarterly, the severity and prolonged effects of the outbreak will likely require a close monitoring of the going concern assessment throughout 2020 and beyond.

Step 1: Assess if substantial doubt is raised

Step 1 involves significant judgment to determine if it is probable (i.e. likely) that the company will be unable to meet its obligations. This assessment is based on known and 'reasonably knowable' conditions and events that exist when the financial statements are issued (available to be issued). Management should make a reasonable effort to identify quantitative and qualitative factors relevant to the analysis, without undue cost and effort. Those factors are assessed in the aggregate and are not limited to negative, internal and external operating trends related to COVID-19.

Although COVID-19 is not an adverse condition or event by itself (see Question 3.5.20 of KPMG Handbook, Going concern), it may translate into adverse conditions and events that raise substantial doubt about a company's ability to continue as a going concern. Examples of potential conditions and events related to COVID-19 are listed in Appendix A.

In addition, Step 1 of the assessment typically considers the company's:

— current financial position, including liquidity sources and access to credit;
— obligations due by the end of the look-forward period; and
— funds necessary to maintain the company's operations.

Step 2: Assess if substantial doubt exists

When substantial doubt is raised, it can be alleviated if management has mitigation plans in place that are expected to be successful. Management plans should only be considered, if it is probable that within the look-forward period: [205-40-50-7 – 50-8]

— plans will be effectively implemented. Plans must be approved before the financial statements are issued (available to be issued) and considered feasible; and
— plans will mitigate the relevant conditions or events that raise substantial doubt.

Management may have a history of successfully forecasting and executing similar plans – e.g. restructuring or refinancing plans, which would normally be indicative of the feasibility of current plans. However, COVID-19 presents unprecedented challenges that may make it difficult to rely on past history to establish future success. It may also be difficult to establish a plan's future success when critical elements of the plan depend on events outside management's control – e.g. availability of credit lines, general market rebound, ability to secure other sourcing. Consequently, alleviating substantial doubt when raised may prove challenging for some companies. Preparing sensitivity analyses on significant assumptions may be necessary to appropriately assess the probability of the results in varying market conditions. Assumptions should be kept consistent across other areas of the financial statements, such as estimates, impairment valuations, etc.

It is important to note that the term 'probable' is used in Steps 1 and 2; however, in opposite ways. Probable is defined in Topic 450 (contingencies) as 'likely to occur'. Step 1 assesses the likelihood of failing to meet obligations, whereas Step 2 assesses the likelihood of success of management's mitigation plans.

Example forecasted debt covenant violation **

A forecasted covenant violation, within or across interim periods in the look-forward period, may indicate a condition or event that raises substantial doubt about the entity's ability to continue as a going concern (Step 1). This would be the case if the covenant breach accelerates the debt maturity and the company does not have sufficient liquidity to satisfy the debt, including any additional cross-default violations from other obligations.

Management may expect the lender will provide covenant waivers in the future – e.g. based on historical experience of obtaining waivers or current discussions with the lender. However, negotiating a waiver is an example of a mitigation plan by management (Step 2).

Such a plan requires the lender's approval, which is a critical element of the plan and is outside of management's control. Plans with critical elements outside of management's control are generally *not* considered probable of being effectively implemented. We believe this is the case even if the lender has provided waivers in the past, because a lender's past actions may not indicate future intentions. This may be especially true if the credit markets or the entity's financial health have significantly declined since the lender granted the previous covenant waivers. See Questions 4.2.30 and 4.2.40 in KPMG Handbook, Going concern.

If effective implementation of management's plans within the look-forward period is not considered probable, or if it is not probable that their mitigating effect will alleviate the substantial doubt within that period, their mitigating effect is ignored for purposes of determining whether substantial doubt about the entity's ability to continue as a going concern exists.

Disclosures

If substantial doubt is raised about the company's ability to continue as a going concern, the following disclosure is required in the financial statements: [205-40-50-12, 50-13]

— conditions and events that raised substantial doubt;
— management's evaluation of the significance of those conditions or events in relation to the company's ability to meet its obligations; and
— management's plans that alleviated (i.e. eliminated) or are intended to alleviate (i.e. have not yet eliminated) the substantial doubt.

If substantial doubt exists, this fact should be explicitly disclosed. If substantial doubt does not exist, we believe the term 'substantial doubt' need not be used. The company can apply judgment as to the appropriate placement of the required information in the notes.

While the look-forward period is one year, it may be appropriate to provide additional disclosure about the potential effect of known conditions and events that may occur beyond one year. Those known conditions and events are often required to be disclosed in accordance with other US GAAP requirements (e.g. loss contingencies, risk and uncertainties (see below), debt) or SEC rules and regulations.

Management's internal control over financial reporting

Management may need to change existing or implement new processes to address the requirements of Subtopic 205-40. For example, a rolling 12-month projection of operating cash flows and liquidity levels may need to be maintained. Those changes will likely introduce new process risks that management needs to evaluate. The outcome of that evaluation may be the identification of new controls that are necessary to address the changing process risks.

Going concern may affect other accounting treatments **

Management should ensure that the going concern assessment, including plans to alleviate substantial doubt, is taken into consideration in, and consistent with, other accounting evaluations that apply to the company. For example, when substantial doubt is raised:

— certain future forecasted transactions may no longer be probable of occurring, which could require a reassessment of hedge accounting for related hedging relationships;

— forecasted debt covenant violations may require current vs. noncurrent debt classification to be revisited. For example, a company's debt agreement may contain a covenant that restricts it from receiving an audit report on its annual financial statements that contain a going-concern modification. Therefore, issuance of such an audit report would result in a covenant violation, making the debt callable by the creditor. See KPMG's Hot Topic, Coronavirus - Potential impacts on the accounting for financial instruments;

- the ability to generate taxable income could be compromised and the valuation allowance on deferred tax assets may need to be adjusted accordingly. See KPMG's Hot Topic, Coronavirus – Income tax accounting impacts; and
- the consequences of management plans to alleviate the substantial doubt need to be considered in other accounting evaluations. For example, management's plans to mitigate liquidity concerns through furloughs or a reduction in workforce may have implications on the accounting for share-based payments and other employee benefit and compensation arrangements, as well as the growth rate assumption used in the goodwill impairment test.

See our other Hot Topics available at read.kpmg.us/coronavirus.

Risk and uncertainties

Topic 275 requirements

Topic 275 requires disclosures about risks and uncertainties that could significantly affect the amounts reported in the financial statements in the near term. These disclosures are incremental to the requirements of going concern (Subtopic 205-40) discussed above and include disclosures addressing certain estimates and significant concentrations in the company's operations. [275-10-05-02]

Estimates

Companies are required to provide qualitative disclosure of estimates when known information available before the financial statements are issued (available to be issued) indicates that: [275-10-50-8]

- it is at least reasonably possible that the effect on the financial statements of a condition, situation or set of circumstances that existed at the reporting date will change in the near term (i.e. within one year of the balance sheet date) due to one or more future confirming events; and
- the effect of the change would be material to the financial statements.

Management should carefully evaluate the estimates included in their financial reporting, considering underlying assumptions, to determine those for which it is reasonably possible that a material change could occur. Reasonably possible means 'more than remote', which we believe sets a fairly low bar for triggering the above disclosures in the context of the wide effects of COVID-19. This low bar contrasts with the relatively high bar of going concern disclosures discussed above. As a result, without substantial doubt existing, a company may still need to provide a significant amount of information pertaining to the risk and uncertainty underlying an estimate.

COVID-19 has created uncertainty for revenue forecasts, sourcing and workforce availability, credit ratings, etc. but also volatility in stock and commodity prices, interest and currency exchange rates. Estimates based on such metrics may be subject to change in the near term, and those changes could be material to the financial statements. Examples of estimates that might be particularly affected by COVID-19 are listed in Appendix B.

Companies should not only identify the estimates sensitive to change, but also explain the reason for the uncertainty. Other Topics, such as Topic 820 (fair value measurements) Topic 450 (contingencies), Subtopic 410-30 (environmental obligations) and Topic 855 (see above), may also require quantitative disclosures.

There is no specific prescribed location in the financial statements for the disclosure of risks and uncertainties. These may be aggregated in one note, or disclosed together with other relevant discussion. Companies should consider the presentation that is most meaningful for financial statement users.

Vulnerability from concentrations

Vulnerability from concentrations may arise when a company is exposed to risk of loss greater than it would have had it mitigated its risk through diversification. This may be the case when a company's supply chain, workforce or customer base depends on a particular geography or market. Such concentrations should be disclosed if they exist at the balance sheet date and it is reasonably possible that they could have a severe impact in the near term. The assessment should also take into consideration known information available before the financial statements are issued or are available to be issued. [275-10-50-16]

While we do not expect that in the short term COVID-19 will change existing concentrations, it is possible that a company needs to revise (and disclose) which of those existing concentrations create vulnerability. For example, a manufacturing company that produces an essential component only in China may have never disclosed this fact because the concentration did not create vulnerability. Because COVID-19 first affected China, the company's ability to continue its worldwide manufacturing operations may now be severely affected, making disclosure of this situation necessary.

Examples of concentrations may include:

- concentrations in the volume of business transacted with a particular customer, supplier, lender, grantor or contributor;
- concentrations in revenue from particular products, services or fund-raising events.
- concentrations in the available sources of supply of materials, labor or services, or of licenses or other rights used in the company's operations.
- concentrations in the market or geographic area in which a company conducts its operations.

COVID-19 likely requires broad disclosures, including in interim financial statements

While not specifically prescribed by Topic 275, companies should consider discussing other risks and uncertainties arising from COVID-19, and how they plan to address these risks. This includes whether the company applies specific risk-reduction techniques, contingency and continuity plans and business interruption insurance.

For example, expected shortages in supplies and labor may not be a required disclosure, but such shortages may be expected to significantly affect the company's financial statements, and constitute decision-useful information for financial statement users.

Topic 275 disclosures are typically not needed in condensed interim financial statements. However, given how fast the COVID-19 situation is changing, companies should consider the need to repeat and update those disclosures at each interim period in 2020 to provide transparency and fairness of presentation. [270-10-50-6]

Unusual items**

Subtopic 220-20 requirements

The financial effects of material events or transactions that are considered to be unusual or infrequently occurring (unusual items) need to be presented as a separate component of income from continuing operations in the income statement or disclosed in the notes to the financial statements. The financial effects are determined before income tax.

Unusual nature represents a situation in which the underlying event has a high degree of abnormality and is not related to the ordinary activities of the entity. Infrequency of occurrence represents an event that would not reasonably be expected to recur in the foreseeable future. [220-20-20, 220-20-45-1A]

Reporting the financial effects of COVID-19 requires judgment

Although this determination is company specific, we believe most companies will consider COVID-19 an unusual event. However, further judgment is needed to define which financial effects, if material, should be presented as a separate component of income from continuing operations or disclosed in the financial statements. This determination has implications beyond just presentation, because significant unusual items that are reported separately are excluded from ordinary income when estimating the annual effective income tax rate used in interim periods; see KPMG's Hot Topic, Coronavirus – Income tax accounting impacts.

Subtopic 220-20 is silent on how to determine which losses and costs are attributable to unusual items and judgment is required in this area. We believe that a reasonable approach would be to include direct and incremental costs or gains associated with COVID-19 – e.g. incremental operating expenses such as cleaning or severance costs and business interruption insurance recoveries. Normal recurring expenses that would be incurred regardless of COVID-19, such as regular payroll costs, overheads or depreciation expense are typically not direct and incremental.

SEC registrants may also consider the requirements in Regulation S-X Rule 5-03 for commercial and industrial companies. The regulation allows registrants to present certain material amounts as a separate line(s) item in the income statement subject to clear disclosure of the nature of those costs. However, certain costs are expected to be part of costs of sales or selling, general and administrative (SGA) expenses, when they relate to activities historically included on those lines. For example, inventory markdowns are expected to be part of costs of sales and be included in gross profit or operating income if those subtotals are presented. [S-X Rule 5-03, 420-10-S99-3]

See KPMG's Hot Topic, SEC provides coronavirus-related disclosure guidance, for discussion of non-GAAP measures.

Considerations for SEC issuers

Since January 2020, in various public statements, the SEC has emphasized the importance of considering the sufficiency of subsequent events disclosures in the context of COVID-19. How an issuer plans for an uncertainty and how it responds to current events can be material to an investment decision. [SEC Public Statement]

SEC issuers should consider the adequacy of disclosures about risks and uncertainties in MD&A and other items in periodic filings. Disclosure within periodic SEC filings to address current and evolving events may be appropriate in:

- Item 1. Description of Business
- Item 1A. Risk Factors
- Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations
- Liquidity
- Results of Operations - Known Trends and Uncertainties
- Strategies and policies to manage risks
- Item 7A. Quantitative and Qualitative Disclosures About Market Risk.

The SEC has encouraged companies to provide robust, forward-looking disclosures – and those that do may avail themselves of the safe-harbor rules for such statements. The SEC has also started monitoring disclosures on current and potential effects of COVID-19. [SEC Public Statement]

See our Hot Topics available at read.kpmg.us/coronavirus for additional guidance on the effect of COVID-19 on financial reporting for SEC issuers.

Evolving information

The potential global and economic impacts of the coronavirus continue to evolve rapidly, and companies should monitor the situation. Companies are encouraged to maintain close communications with their board of directors, external auditors, legal counsel and other service providers as the circumstances progress. Stay informed at read.kpmg.us/coronavirus

Contact us

Valerie Boissou
Partner
+1 212 954 1723
vlesageboissou@kpmg.com

Tim Phelps
Partner
+1 212 872 3249
tphelps@kpmg.com

Appendix A: Examples of business risks relevant to the subsequent events and going concern analysis

Customer demand	— Is the company experiencing (or expecting) any changes in customer demand or consumption behavior? — How sensitive is demand and pricing to exchange rates and/or commodity indices (e.g. volatility of crude oil prices)?
Supply chain	— Is the company experiencing (or expecting) supply chain impacts such as shortages related to the import/export of machinery, components or raw materials? — Is the company making new arrangements to purchase goods from sources outside of the affected areas? Will there be significant costs or other risks associated with those alternative arrangements? — Is the company experiencing (or expecting) issues with the flow of goods and trade due to travel restrictions, canceled passenger and cargo shipments by airlines, or border closings?
Products and services	— Are there risks of production delays or product shortages? — Is the company experiencing plant, store or office closures? — Is the company impacted by rent concessions or abatements associated with office and/or retail closings?
People	— Is the company experiencing staffing shortages due to quarantines? — Does the company have a large workforce that is affected? — Could certain employee compensation matters result in material costs?
Markets	— Is the company heavily invested in stocks? — To what extent is the company exposed to the global economy? — Is the company exposed to volatility in commodities markets impacted by current events? — Is the company exposed to foreign currencies whose exchange rates are significantly affected by COVID-19?
Operations	— Are the company's current and future results of operations impacted? — Can the company implement business continuity plans? — Has the company been able to maintain operations, including financial reporting systems, internal control over financial reporting, and disclosure controls and procedures?
Financial condition	— Is the company experiencing (or expecting) liquidity issues? — Is debt becoming callable in the foreseeable future?

Appendix B: Examples of financial statement estimates potentially affected by COVID-19

Inventory	— Inventory write-downs — Purchase commitments — Idle plant capacity, abnormal manufacturing overhead costs and price variances — Temporary LIFO liquidation See the Revenue, Inventory and other related costs Hot Topic at read.kpmg.us/coronavirus.
Debt subject to loan defaults or covenant breaches	Assessment to determine if covenants or loan default is expected or cross-default provisions could be triggered. See the Debt Equity Hot Topic at read.kpmg.us/coronavirus.
Loan and receivables	Uncertainty surrounding current expected credit loss estimates (post-ASU 2016-13) and loss reserves subject to changes in credit risk from customers or other debtors negatively affected (pre-ASU 2016-13). See the Expected Credit Losses Hot Topic at read.kpmg.us/coronavirus.
Insurance recoveries	The timing of recognizing insurance recoveries can be subject to uncertainty based on the terms of the agreement as well as timing of payments and collectibility.
Fair value measurements	General uncertainty surrounding discount rates, growth rates, etc.
Long-lived assets impairment evaluations	Evaluations of goodwill, tangible and intangible assets, and equity method investments. See the Impairment of Nonfinancial Assets Hot Topic at read.kpmg.us/coronavirus.
Revenue recognition	— Variable consideration, including effect of price concessions, right of return, etc. — Customer credit risk — Breakage See the Revenue, Inventory and other related costs Hot Topic at read.kpmg.us/coronavirus.
Leases	Collectibility of the lease payments (and any amount necessary to satisfy a residual value guarantee) may not be probable. See the Rent Concessions and Leases Hot Topics at read.kpmg.us/coronavirus.

Leases	Collectibility of the lease payments (and any amount necessary to satisfy a residual value guarantee) may not be probable. See the Rent Concessions and Leases Hot Topics at read.kpmg.us/coronavirus.
Cash flow hedge accounting subject to the probability of occurrence of future forecasted transactions	Future forecasted transaction may not be probable. See the Financial Instruments Hot Topic at read.kpmg.us/coronavirus.
Bonus plans and liability-classified share-based payment arrangements based on achieving certain targets	Targets may not be met. For further considerations, see the Compensation and Benefits Hot Topic at read.kpmg.us/coronavirus.
Deferred taxes and valuation allowances	Deferred tax assets may not be utilizable if revenue forecasts change, and timing of reversal may be uncertain. For further considerations, see the Income Tax Hot Topic at read.kpmg.us/coronavirus.