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ACCOUNTING GUIDANCE RELATED TO NATURAL DISASTERS

In the aftermath of recent natural disasters including Hurricanes Harvey, Irma, and Maria, as well as earthquakes in Mexico, this FASB Flash Report is intended as a resource for the related financial reporting issues. These matters may impact third quarter interim reports for SEC registrants. The accounting guidance differs by the type of loss, but practitioners should bear in mind that the losses are generally reflected in the accounting period of the natural disaster, independent of any potential insurance proceeds, which are accounted for separately.

Asset Impairment and Contingent Losses

As a result of natural disasters many assets may be destroyed, damaged or impaired. When considering if impairment exists, an entity should first determine the condition of the asset. If an asset is destroyed, it should be written off as an expense. Otherwise, an impairment may be required.

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CONTACTS

YOSEF BARBUT

National Accounting Partner
212-885-8292 / ybarbut@bdo.com

ADAM BROWN

National Accounting Partner
214-665-0673 / abrown@bdo.com

GAUTAM GOSWAMI

National Accounting Partner
312-616-4631 / ggoswami@bdo.com

JENNIFER KIMMEL

National Accounting Senior Manager
617-239-7019 / jkimmel@bdo.com

JIN KOO

National Accounting Partner
214-243-2941 / jkoo@bdo.com

JON LINVILLE

National Accounting Director
214-243-2940 / jlinville@bdo.com

ANGELA NEWELL

National Accounting Partner
214-689-5669 / ajnewell@bdo.com

Receivables and Loans.

Receivables and loans from entities impacted by natural disasters might be at risk for collectability. Receivables and loans are subject to ASC 310 and ASC 450-20. A loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. Loan impairment is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate, except as a practical expedient, impairment can be measured based on a loan's observable market price or the fair value of the underlying collateral.

Inventory

Under ASC 330-10-35, inventory measured using any method other than LIFO or the retail inventory method is carried at the lower of cost or net realizable value. When the net realizable value of inventory is lower than its cost, the inventory should be written down and recognized as a loss in earnings in the period in which it occurs. For inventory measured using LIFO or the retail method, an adjustment is required when the utility of the goods is no longer as great as their cost. Where there is evidence that the utility of goods will be less than cost, the difference is recognized as a loss of the current period.

Indefinite-Lived Intangible Assets

Indefinite-lived intangible assets are addressed under ASC 350-30-35. They are tested for impairment annually, or more frequently if events or circumstances indicate the asset might be impaired, by comparing the fair value of the assets to their carrying amount. Alternatively, an entity may first perform a qualitative assessment to determine whether it is necessary to perform the quantitative assessment described in ASC 350-30-35-19. Note, an indefinite-lived intangible asset is initially tested for impairment before a larger asset group that includes the intangible asset is assessed for recoverability.

Property, Plant and Equipment and Finite-Lived Intangibles

Property, plant and equipment held for use and finite-lived intangibles are subject to ASC 360-10. They are tested for recoverability whenever events or circumstances indicate that the carrying amount of the asset group may not be recoverable. If the asset group is not recoverable, its carrying amount is reduced to its fair value.

Alternatively, if an entity concludes that it will sell long-lived assets and the "held for sale" criteria are met, a loss should be recognized for a write-down of the disposal group to fair value less costs to sell.

Goodwill

Goodwill is subject to ASC 350. It is tested for impairment at the reporting unit level at least annually, or more frequently if an event occurs or circumstances change that would more likely than not reduce the fair value of the reporting unit below its carrying amount. When the carrying amount of a reporting unit is less than its fair value, the implied fair value of goodwill must be calculated to determine the amount of goodwill impairment, if any. Similar to indefinite-lived intangibles, an entity could choose to first perform a qualitative assessment to determine whether a quantitative assessment is needed. Goodwill is tested for impairment only after indefinite-lived intangible assets and amortizing assets, such as PP&E, have been assessed. Private companies currently have an option to elect a simplified method of accounting for goodwill. In addition, the amendments in ASU 2017-04, *Simplifying the Test for Goodwill Impairment* should be applied when effective, which is periods beginning after December 15, 2019 for public companies.¹ ASU 2017-04 may be early adopted. For additional information on ASU 2014-04 see BDO's Flash Report [here](#).

Contingent losses

Liabilities related to natural disasters are addressed by ASC 450-20, in the absence of other GAAP (see discussion of "Exit Activities" below). A liability should be accrued by a charge to income if it is probable that it has been incurred at the financial statement date and the amount of the loss can be reasonably estimated. This includes, for example, the costs of repairs and maintenance that are not capitalized.

Exit Activities

Following a natural disaster an entity may choose to sell or terminate a line of business, close the business activities in a particular location, relocate the business activities from one location to another, make changes in the management structure, or undergo a fundamental reorganization that affects the nature and focus of operations. All of these items represent exit activities accounted for under ASC 420, *Exit and Disposal Cost Obligations*.

¹ A public business entity that is not an SEC filer should adopt the amendments for its annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2020. All other entities, including not-for-profit entities, should adopt the amendments for their annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2021.

These costs include:

- ▶ Involuntary employee termination benefits pursuant to a one-time benefit arrangement that, in substance, is not an ongoing benefit arrangement or an individual deferred compensation contract.
- ▶ Costs to terminate a contract that is not a lease.
- ▶ Other associated costs, including costs to consolidate or close facilities and relocate employees.

A liability for a cost associated with an exit or disposal activity is recognized at fair value in the period in which the liability is incurred, (except for a liability for one-time employee termination benefits that are incurred over time). If fair value cannot be reasonably estimated, the liability is recognized in the period in which fair value can be reasonably estimated.

A liability for costs that will continue to be incurred under an operating lease for its remaining term without economic benefit is recognized at the cease-use date.²

Temporary Differences and Deferred Income Tax Liabilities

Book recognition of reserves, accruals and impairments would likely impact the measurement of temporary differences and related deferred income taxes under ASC 740. Careful consideration of deferred income taxes including the valuation allowance is required in the period that book losses, reserves and impairments are recognized. The only exception is the impairment of nondeductible goodwill for which no deferred tax effect should be recognized. For income tax purposes, uncollectible receivables can be deducted when they are considered "worthless". The worthlessness of a debt is a question of fact. Obsolete inventory can be deducted when it is no longer able to be used or sold in a "normal" manner and it is being disposed of through a liquidator or junkyard, a donation or it is destroyed.

Balance Sheet Presentation

Asset impairments and liabilities related to natural disasters should be recognized independent of any related insurance recoveries. Liabilities are usually shown gross. This is because the conditions for netting the liabilities against an insurance receivable under ASC 210-20 are not typically satisfied as the insurance receivable and claim liability are with different counterparties.

Income Statement Presentation

ASC 225-20-45-16 states a material event or transaction that an entity considers unusual, infrequent or both is reported as a separate component of income from continuing operations.

The nature and financial effects of each event or transaction is presented separately or disclosed in notes to the financial statements. Gains or losses of a similar nature that are not individually material are aggregated.

Losses from natural disasters that are unusual, infrequent or both, should be reported as a component of income from continuing operations on the statement of operations or disclosed in the footnotes.

Generally, a loss and the related insurance recovery may be presented in the same line item, as limited specific classification guidance exists for these items.

Involuntary Conversions

An involuntary conversion is the exchange, or conversion, of a nonmonetary asset (e.g., fixed assets) to monetary assets such as insurance proceeds. To the extent the cost of a nonmonetary asset is less than the amount of monetary assets received, the transaction results in a gain. This is true even if the insurance proceeds are reinvested in replacement nonmonetary assets, such as new equipment.

In some cases, a nonmonetary asset may be destroyed or damaged in one accounting period and the amount of monetary assets to be received is not determinable until a subsequent accounting period. In those cases, any gain is recognized in accordance with the contingent gain guidance in ASC 450-30. Specifically, the gain should be recognized when all uncertainties have been resolved (typically when cash is received), at which point it is considered realizable. However, if the insurance recovery is determinable, such as when the insurance company does not dispute the claim, a recovery equal to the amount of the loss should be recognized when its receipt is considered probable.

Example

Assume that flooding caused physical damage to property and equipment. The damage to the equipment, having a carrying value of \$1,000, was complete. The property was partially damaged; the portion of the building declared uninhabitable had an allocated carrying value of \$5,000. There is insurance in place which will cover the cost to replace the equipment and repair the building, where the carrier has confirmed coverage of the claim and it is not being disputed by the insurance company. The estimated cost to do both is \$10,000.

² Upon the adoption of ASC 842, the right-of-use asset will be evaluated for impairment under ASC 360.

The company would record an impairment loss of \$6,000 (and reduce its recorded balance of property and equipment) in the period of the flood. Further, the company would record an insurance recovery of \$6,000 to reflect the proceeds from the insurance coverage to the extent of the asset write-off because recovery of that amount is considered probable in the circumstances. In the period the new equipment is purchased and repairs are made to the property, the company would record capital additions of \$10,000. Additionally, in the period the company receives the incremental \$4,000 of proceeds from the insurance coverage, it would record a gain on the involuntary conversion of that amount. Note that if the insurance company in this example denied or contested coverage, it may be inappropriate for the company to record any benefit of the coverage until such time that all uncertainties surrounding the extent of coverage is resolved – usually at the time cash is received from the insurance company.

Insurance Proceeds

As mentioned previously, impairment losses are generally accounted for separate from any related insurance. With respect to accounting for insurance proceeds, GAAP includes the following guidance.

Business Interruption

Natural disasters often cause disruptions in operations which result in losses. These losses are often covered by business interruption insurance and should be accounted for separate from other insurance proceeds. ASC 225-30 covers the presentation of business interruption insurance and defines business interruption insurance as “insurance that provides coverage if business operations are suspended due to the loss of use of property and equipment resulting from a covered cause of loss. Business interruption insurance coverage generally provides for reimbursement of certain costs and losses incurred during the reasonable period required to rebuild, repair, or replace the damaged property.”

When losses incurred can be reasonably estimated and recovery is considered probable a receivable may be recorded. However, the amount recorded should not be greater than costs incurred to date. Therefore, proceeds for lost profits are treated as a contingent gain and typically recorded at the settlement date.

If business interruption insurance is received, entities may elect a policy for how such amounts are presented in the income statement as long as it does not conflict with other applicable GAAP.

In connection with business interruption insurance proceeds, the notes to the financial statements should disclose the nature of the event resulting in business interruption losses and the aggregate amount of business interruption insurance recoveries recognized during the period and the line items in the income statement in which those recoveries are classified.

Property and Casualty

The cash flow presentation of property insurance proceeds covering damage or loss depends on the nature of the property. For example, insurance proceeds received in connection with leased property would be classified as operating cash flows for an operating lease or as investing cash flows for a capital lease.

Cash Flow Statement Presentation

Since insurance proceeds are classified based on the nature of the insurance coverage rather than the intended use of the proceeds, amounts received for business interruption, inventory losses and operating lease assets are presented as operating activities. If insurance proceeds are received for the loss of property, plant and equipment, they should be presented as investing cash flows.

In addition, when cash proceeds from insurance are significant, SEC registrants should disclose where the proceeds are classified in the statement of cash flows and discuss the insurance proceeds or settlements in MD&A. The discussion should include a description of the proceeds or settlement, why it was received, planned use for the receipts and any impact to reported earnings.

Derivative and Hedge Accounting

A key requirement for obtaining cash flow hedge accounting is that the hedged forecasted transaction is probable of occurring. Natural disasters can affect operations, causing some transactions to be curtailed, delayed or canceled. Companies that have designated forecasted transactions in cash flow hedging relationships e.g., purchases or sales of goods, or interest payments on debt, may determine that the hedged transaction is no longer probable of occurring within the originally specified time period, in which case hedge accounting should be discontinued prospectively. However, the related gains and losses in accumulated other comprehensive income should be reclassified in earnings only if it is probable that the forecasted transaction will not occur by the end of the period originally specified or within an additional two-month period thereafter. Reclassification of gains and losses would also affect deferred income tax accounting and intraperiod allocation under subtopic 740-20.

Natural disasters also may affect the eligibility for the “normal purchases and normal sales” scope exception to derivatives accounting for commodity contracts e.g., oil and gas. This exception is based on physical delivery and if that is no longer probable due to curtailment or cancelation of operations such that the contract instead would now settle net, the eligibility for applying this scope exception would no longer be met. Consequently, the contract should be recorded on the balance sheet at its current fair value and subsequently continue to be marked to fair value, similar to any other derivative.

Other Accounting Considerations

Natural disasters affect many aspects of a business. Additional consideration should be given to items such as debt, investments (including debt and equity securities, equity and cost method investments and investments in joint ventures), going concern, subsequent events, environmental remediation obligations, fair value estimates, and stock compensation.

In addition, entities should disclose the material event or transaction that gave rise to an unusual or infrequent loss, as described in ASC 225-20-45-16. Entities should also consider disclosures about risks and uncertainties in ASC 275-10-50. Further, natural disasters may trigger incremental disclosures for SEC reporting purposes.

Additional Resources

- ▶ SEC Press Release 2017-164, SEC Monitoring Impact of Hurricane Irma on Capital Markets, Continues to Monitor Impact of Hurricane Harvey
- ▶ IRS News Release IR-2017-135, IRS Gives Tax Relief to Victims of Hurricane Harvey; Parts of Texas Now Eligible; Extension Filers Have Until Jan. 31 to File

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