COVID-19's Impact on Accounting Concepts — Inventory, Goodwill and Asset Impairment

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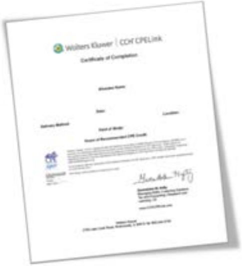

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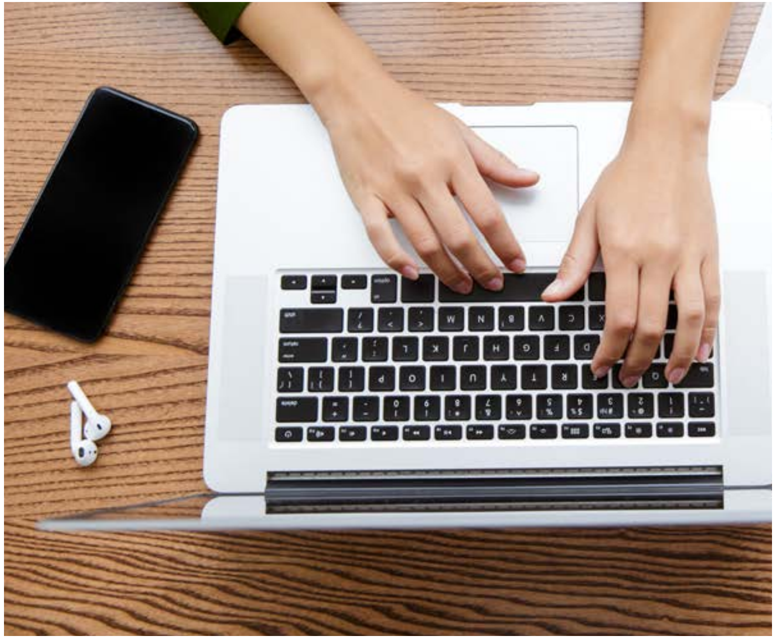
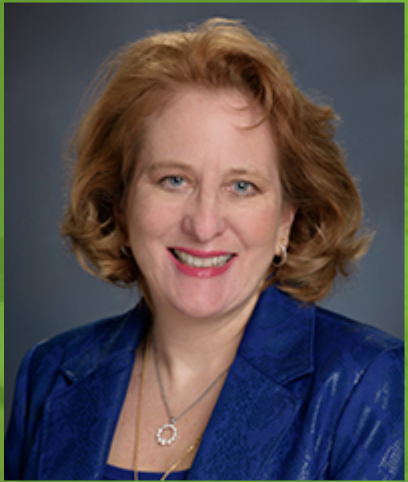


Lynn Fountain



Lynn Fountain has over 38 years of experience spanning public accounting, corporate accounting and consulting. 20 years of her experience has been working in the areas of internal and external auditing and risk management. She is a subject matter expert in multiple fields including internal audit, ethics, fraud evaluations, Sarbanes-Oxley, enterprise risk management, governance, financial management and compliance.

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Introduction

- The U.S. continues to struggle through the COVID-19 and accountants continue the process of evaluating accounting impacts.
- Previous sessions have discussed impacts of financial statement disclosures, revenue recognition, leases estimates and assumptions, going concern and subsequent events.
- This month we will turn our focus to inventory (valuation and physical inventory), impact on goodwill and asset impairment

Agenda

- Explore difficulties and alternatives when conducting physical inventory observations.
- Evaluate the impacts on inventory valuation and inventory levels.
- Examine impact on goodwill and goodwill impairment requirements.
- Evaluate concepts of asset impairment.
- Finding additional resources in CCH® Accounting Research Manager®

POLLING QUESTION

Of today's topics, which has most significantly impacted your company?

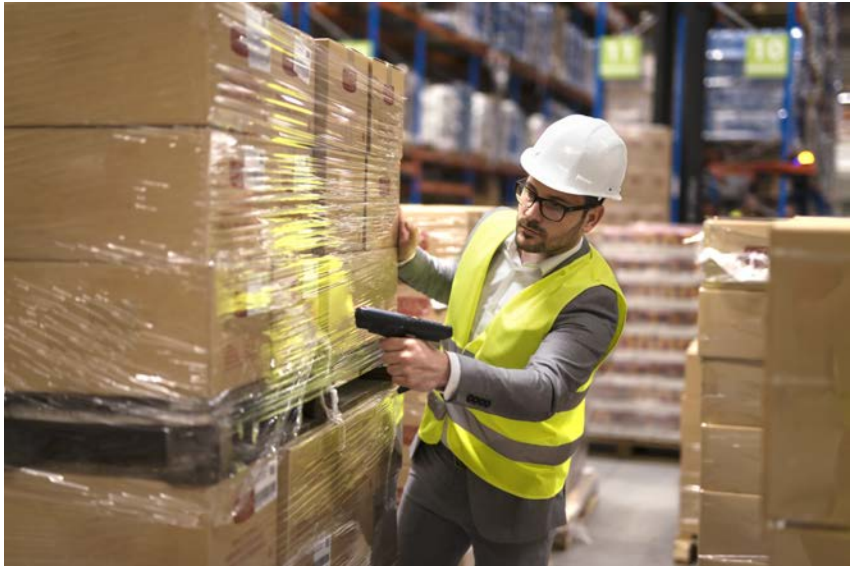
A. Inventory
B. Goodwill
C. Impairment of Assets

Inventory

Inventory

- The COVID-19 pandemic may affect inventory in a number of ways due to.
  - Shortages of labor
  - Materials or unplanned factory downtime
  - Obsolesce
  - Slow-moving inventory
  - Inventory physical counts
- Due to the length of the pandemic, production levels may be impacted.

Inventory *(cont'd)*



- Determine whether inventory on hand has been impaired.
- ASC 330 - most inventory is measured at lower of cost or:
  - Market value (for inventory measured by using last in, first out [LIFO] or the retail inventory method) or
  - NRV (for all other inventory).
- Valuation of inventories is subject to IAS 2 *Inventories.*

Inventory *(cont'd)*

- COVID necessitates NRV calculations utilize more detailed methods.
  - Potential need to write-down stock due to less sales.
  - Interim inventory impairment losses should be reflected in the interim period they occur.
    - Subsequent recoveries recognized as gains in future periods.

Inventory *(cont'd)*

- COVID-19 may affect the recoverability of inventory balances.
  - Seasonal inventories or inventory that could expire may need to be assessed for obsolesce reserves.
  - May have to assess whether a decline in future estimated SP may require a write-down in the cost of inventory.
  - May have to reassess practices for fixed overhead cost absorption if production volumes become abnormally low.

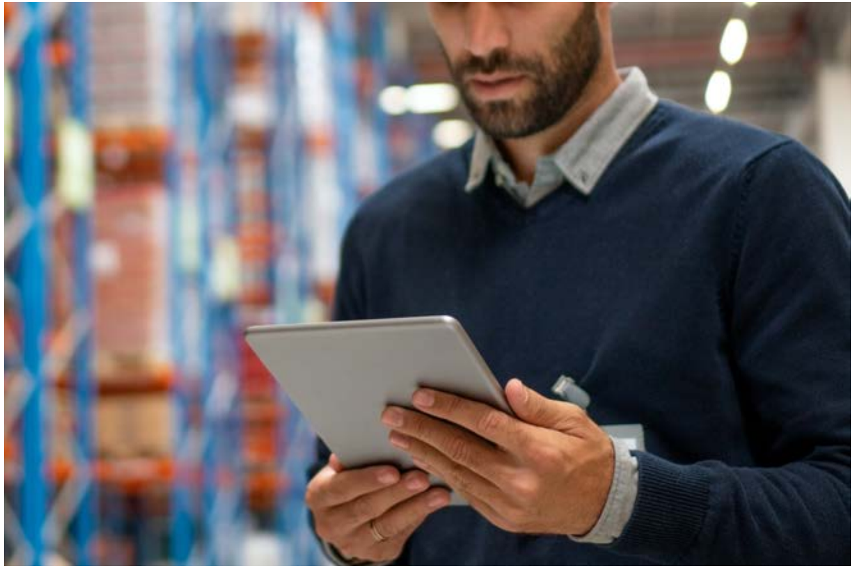
Inventory *(cont'd)*

- Per ASC 330 variable production overhead costs are "allocated to each unit of production on the basis of the actual use of the production facilities."
    - Allocation occurs on expectation production facilities running at **normal production** capacity.
    - Do not increase the amount of fixed overhead costs allocated to each inventory item.
    - The unallocated fixed overhead costs are recognized in profit or loss in the period incurred.

Physical Inventory

- Management not conducting a count on the balance sheet date.
  - Consider whether this could impose restrictions on ability to obtain sufficient audit evidence.
  - Consider whether possible to delay count to when restrictions are lifted.
  - In either circumstance governing bodies must be informed.
- Physical inventory conducted on a date other than balance sheet date.
  - Information on changes in inventory between count date and FS date is important.
  - Entity must evaluate effectiveness of design and execution of controls over inventory procedures to determine whether such a count can be relied on.

Physical Inventory *(cont'd)*



- Availability/usability of technology
  - Understand the technology and any practical constraints in its use.
  - Ensure security on technology controls.
  - If performing test remotely — determine procedures that provide same/similar assurance as perfuming on-site.

Inventory *(cont'd)*

- Inability of auditor or others to attend physical counts
  - Can sufficient alternative audit procedures be performed to obtain sufficient evidence or is there an audit scope limitation.
    - Vouching purchases and sales to a from perpetual records.
    - Performing substantive analytic procedures.
    - Testing sales/purchases for proper cut-off
    - Testing accuracy of cut-off period
    - Validating procedures of reconciliation to the GS.
  - Scope limitation could result in modification to auditors opinion.

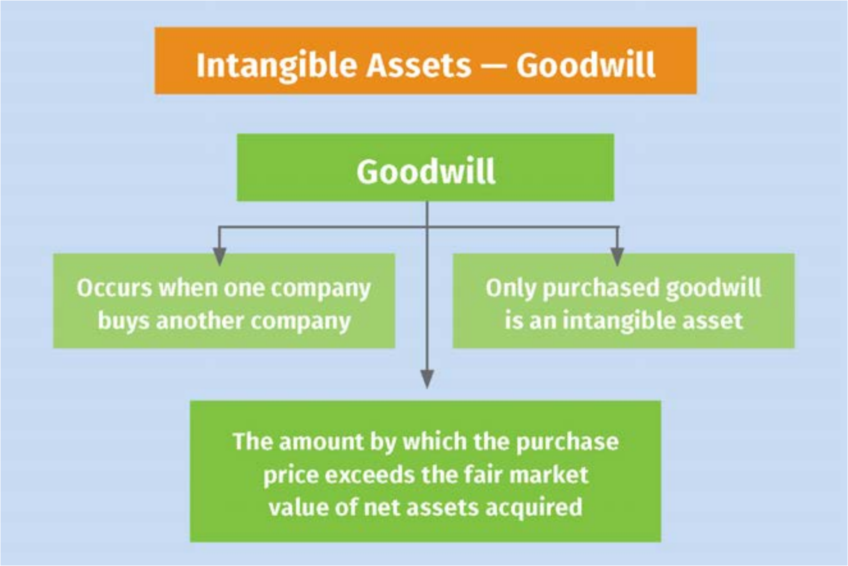
Goodwill

Goodwill

- More entities may test goodwill of one or more reporting units for impairment between annual testing dates.
  - Under ASC 350, an entity is required to test goodwill for impairment at the reporting-unit level at least annually or
    - *"between annual tests if an event occurs/circumstances change that would more likely than not reduce the FV of a reporting unit below its carrying amount."*

Goodwill *(cont'd)*

- Conditions include:
  - A deterioration in general economic conditions
  - A deterioration in the environment in which an entity operates
  - A change in the market for an entity's products or services
  - Overall financial performance such as negative or declining CF's or a decline in actual or planned revenue or earnings compared with actual and projected results of relevant prior periods"



Goodwill *(cont’d)*

- A part of goodwill impairment analysis is valuation.
  - Quality impacted by quality of projections.
- Uncertainty requires companies to rethink valuation approach.
  - Forecasting challenges due to past performance indicators not being indicative of future results.
  - If company's “cushion” (excess of the reporting unit’s fair value over carrying amount) decreased, monitoring needs went up.
- Companies using scenario-based forecasting approaches.
  - Understand key drivers of estimates and reliability of inputs
  - Inherent uncertainty with key assumptions used in impairment testing require internal controls to be designed and updated to ensure quality data is available and identified.

Asset Impairment Testing

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Impairment Testing

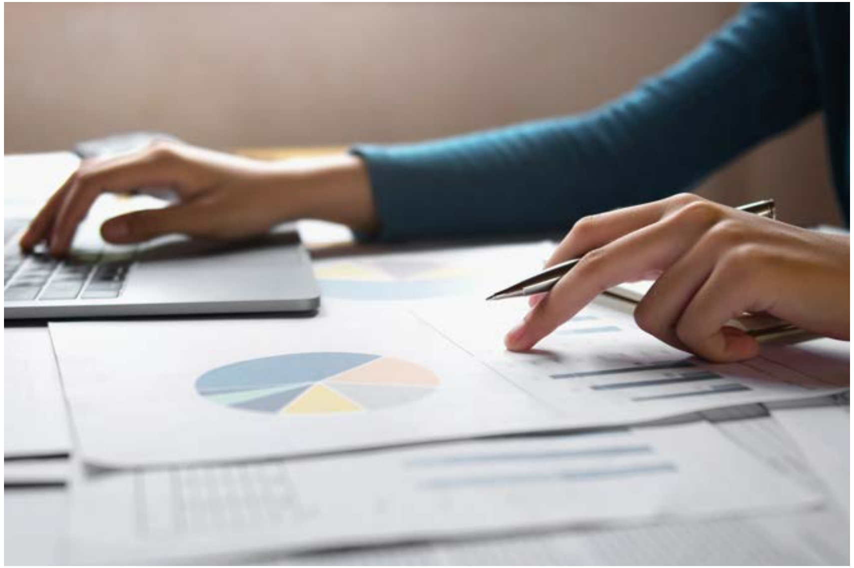
- **Impairment test** — an accounting procedure to determine if asset is impaired (economic benefits of asset drastically decreased).
  - Under GAAP, if cash value of an asset exceeds the sum of undiscounted expected cash value of an asset, the asset is **impaired**.
    - Entities should consider whether conditions exist that indicate assets should be tested for impairment.
    - Even assets with an annual impairment testing requirement should be tested if a triggering event occurs.

Potential Triggering Events

- Shifts in market forecasts
- Fluctuations in materials or labor costs
- Increases in costs of borrowing
- Changes in availability of financing
- Company is experiencing or expecting future net losses in operations
- Shifts in stock prices
- Changes in management or losses of key employees
- Changes in foreign exchange rates
- Supply chain shortages

Asset Impairment

- Economic conditions caused by COVID-19 may or may not be considered a triggering event for your business.
  - Criteria for a triggering event is met when it is more likely than not that asset or reporting unit's recoverable amount (or fair value) is less than its book (or carrying) value.
- If not triggering event occurred, still analyze the impact the event had on operations.
  - Document the factors considered that lead to your conclusion.



Asset Impairment *(cont'd)*

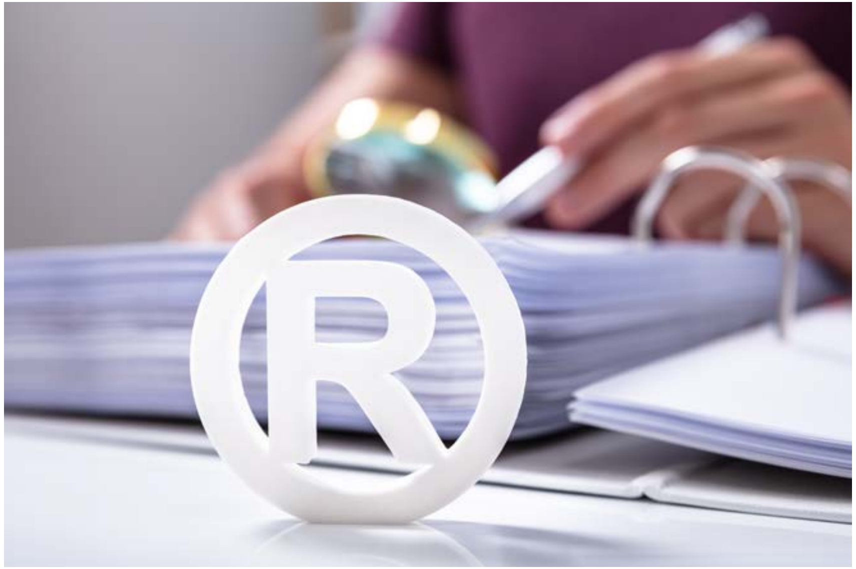
- Nonfinancial assets (**asset** that obtains its value from its physical traits (e.g. real estate or vehicles) use impairment models and rely on development of cash value projections.
  - Impairments establish a **new cost basis** for the assets and **do not** permit the subsequent reversal of the recorded impairment.
  - Good-faith estimates could result in material recorded impairments if:
    - Unforeseen developments occur, the recognized impairment may not longer be appropriate, but it cannot be reversed.

Recoverability and Impairment of Assets

- Assets are tested in a certain order to ensure adjustments are made before including assets in testing of larger units.
- Assets not held for sale required to be tested for impairment in the following order:

1. assets outside of the scope of ASC 360-10 (other than goodwill) such as inventory, capitalized costs to obtain or fulfill a revenue contract, and indefinite-lived intangible assets,
2. long-lived assets in accordance with ASC 360-10, and
3. goodwill in accordance with ASC 350-20

Indefinite-Lived Intangible Assets Other Than Goodwill



- COVID-19 may have resulted in the need to evaluate indefinite-lived assets for impairment.
  - An indefinite-lived intangible asset is one which “there is no foreseeable limit on the period of time over which it is expected to contribute to the cash flows of the reporting entity.”
    - Certain brands, trademarks, or licenses are common examples.
- These assets are tested annually for impairment
  - Impairment loss is recognized if the fair value of the asset is equal to the excess of the carrying amount of the intangible asset over its fair value.

Indefinite-Lived Intangible Assets Other Than Goodwill *(cont'd)*

- A valuation technique applied to measurement of a brand or trademark is the relief from royalty method.
  - Focuses primarily on expected revenues/royalty rates and requires fewer assumptions than other methods.
  - **During the pandemic, it may be challenging to project revenues.**
  - Entities are expected to use their best estimate of all required business and valuation assumptions for this or other income methods.

Indefinite-Lived Intangible Assets Other Than Goodwill *(cont'd)*

- Must consider if there are indicators that an intangible asset classified as indefinite-lived has become finite-lived.
  - May occur if entity changes its expected use of the asset in response to the effects of the COVID-19 pandemic.

POLLING QUESTION

What topic would you like covered in next months Lunch and Learn?

A. Cybersecurity concerns in current environment
B. Impact of technology innovation on accounting
C. Managing a remote workforce
D. Environmental, Social and Corporate Governance issues (ESG)

Additional Answers in CCH® Accounting Research Manager®

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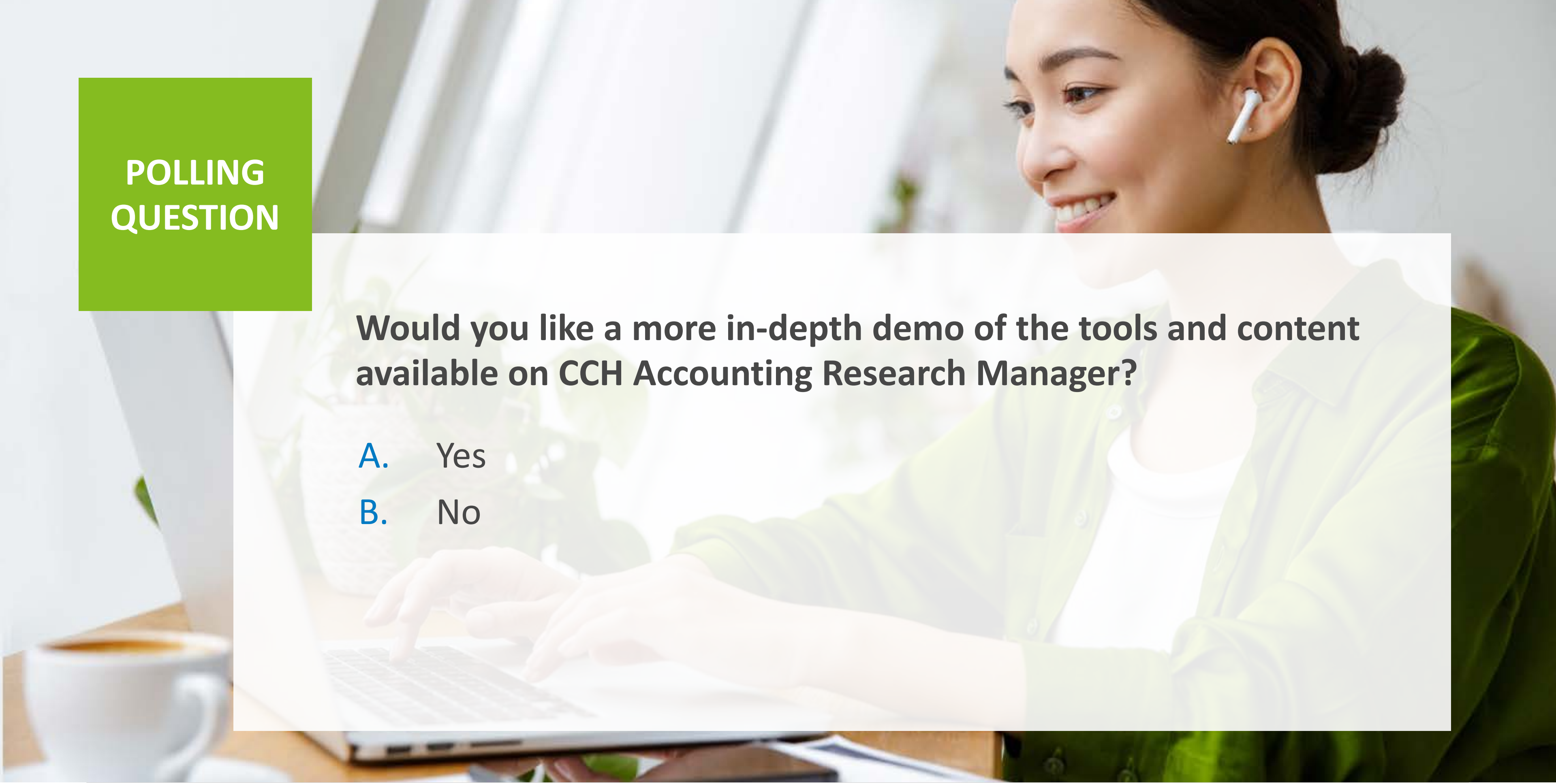
Beth Patrick is a Solutions Consultant at Wolters Kluwer and has over 20 years' experience serving Accounting Professionals. She works with both CPA firms and Corporations sharing best practices to ensure they are utilizing CCH Accounting Research Manager to its fullest.



POLLING QUESTION

Would you like a more in-depth demo of the tools and content available on CCH Accounting Research Manager?

A. Yes

B. No

Thank you for attending

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