What you need to know

- Companies need to consider a number of potential financial reporting effects under US GAAP following a natural disaster.
- Assets may be impaired, either directly or indirectly, and companies should evaluate whether they need to provide additional disclosure.
- Companies need to keep in mind that anticipated insurance proceeds up to the amount of loss recognized are considered insurance recoveries and accounted for only when they are deemed probable. Anticipated insurance proceeds in excess of recognized losses are gain contingencies.
- Companies should consider whether changes in the probability of forecasted transactions occurring at the same time and in the same amounts as they initially expected affect their ability to use hedge accounting.
- This publication has been updated to reflect new guidance on accounting for leases under ASC 842 and credit impairment under ASC 326, among other things.

Overview

When a natural disaster strikes, companies often have questions about how to account for the effects under US GAAP.

This publication provides an overview of some of the accounting and reporting guidance that companies directly and indirectly affected by natural disasters should consider.
Asset impairments

Asset impairments may be indicated as a direct or indirect result of a natural disaster. If a manufacturing facility is damaged by a hurricane, that would be an example of a direct result that may indicate an asset impairment. A jump in operating costs at a facility outside the affected region resulting from the replacement of a supplier in the region with a more costly supplier could be an example of an indirect result that may indicate an asset impairment, depending on the significance and duration of the expected change. That is, short-term, temporary disruptions do not typically indicate an impairment.

If a company determines that the direct or indirect effects of a natural disaster are an indicator of impairment and that impairment tests are required, the company needs to determine the order in which to perform those tests. Indefinite-lived intangible assets are tested first for impairment in accordance with ASC 350, Intangibles – Goodwill and Other. The asset group is then tested for impairment in accordance with ASC 360, Property, Plant, and Equipment. Goodwill impairment is tested last, at the reporting unit level.

After the adoption of ASC 842, Leases, asset groups tested for impairment in accordance with ASC 360 may include right-of-use assets arising from all recognized leases, including operating leases. Refer to our Financial reporting developments publication, Lease accounting (ASC 842), for more information.

The impairment provisions in ASC 360 require that a long-lived asset (group) to be disposed of other than by sale (e.g., abandoned) be classified as “held and used” until disposal (abandonment). If an indicator of impairment is present, an impairment analysis is required. Indicators of impairment as a result of a natural disaster might include:

- A significant decrease in the market price of the asset (group)
- A significant adverse change in the extent or manner in which a long-lived asset (group) is being used or in the physical condition of the asset (group)
- A current expectation that the asset (group) will more likely than not be sold or otherwise disposed of significantly before the end of its previously estimated useful life

ASC 360 also establishes the criteria to classify an asset (group) as “held for sale.” The complete destruction of a long-lived asset results in the write-off of that asset rather than an impairment. That is because the complete destruction of an asset is effectively a disposal of the asset. Refer to our Financial reporting developments publication, Impairment or disposal of long-lived assets, for more information.

Entities with financing activities should consider the guidance in ASC 310, Receivables, before they adopt Accounting Standards Update (ASU) 2016-13, Financial Instruments—Credit Losses (Topic 326), and ASC 326, Financial Instruments—Credit Losses, after they adopt the ASU, to evaluate receivables from counterparties that have operations or underlying collateral in areas affected by natural disasters. They should also evaluate receivables from counterparties that don’t have operations in the affected areas but have significant sales or suppliers in affected areas.

After they adopt ASU 2016-13, entities should also assess contract assets for impairment in accordance with ASC 326. Contract assets represent an entity’s conditional right to consideration for goods or services it has provided if that right is conditioned on something other than the passage of time. Refer to our Financial reporting developments publication, Credit impairment under ASC 326, for more information. Other assets for which impairment guidance exists include:

- Inventory (ASC 330)
Debt securities (ASC 320 before the adoption of ASU 2016-13 and ASC 326 after the adoption of ASU 2016-13)

Equity securities (ASC 320 before the adoption of ASU 2016-01, Financial Instruments—Overall (Subtopic 825-10), and ASC 321 after the adoption of ASU 2016-01)

Equity method investments and investments in joint ventures (ASC 323)

Other investments (ASC 325)

Deferred tax assets (ASC 740)

Net investments in sales-type leases and direct financing leases (ASC 310 before the adoption of ASU 2016-13 and ASC 326 after the adoption of ASU 2016-13)

For asset impairments not addressed by other literature, ASC 450, Contingencies, provides guidance on the initial and subsequent measurement and recognition of loss contingencies.

While the impairment of net investments in sales-type leases and direct financing leases is considered above, ASC 842 also requires lessors to evaluate collectibility of lease payments (and any residual value guarantee) under an operating lease. If a lessor determines it is no longer probable of collecting lease payments and any residual value guarantee from an affected lessee under an operating lease, the lessor's lease income is limited to the lesser of (1) the income that would have been recognized if collection were probable, including income from variable lease payments, and (2) the lease payments, including variable lease payments, that have been collected from the lessee. In such circumstances, lease income is reversed if the lease payments, including variable lease payments, that have been collected from the lessee are less than the lease income recognized to date. Refer to our Financial reporting developments publications, Lease accounting (ASC 842), for more information.

Companies should also consider the accounting for asset retirement obligations under ASC 410-20, Asset Retirement and Environmental Obligations — Asset Retirement Obligations. These liabilities may no longer be necessary or estimates of the amount and timing of future cash flows may need to change if the related asset has been damaged or destroyed. Changes in the amount or timing of undiscounted cash flows also affect the capitalized cost of the asset and therefore could affect the impairment analysis of the asset. See the Asset retirement obligations and environmental costs section of this publication for a further discussion of the accounting for an asset retirement obligation (ARO).

**Insurance recoveries**

Companies may receive insurance proceeds to compensate them for liabilities they incur and assets that are lost or damaged in a natural disaster. Examples of liabilities incurred include costs to repair a damaged facility or costs to remediate environmental damage. As discussed above, a company may determine that a long-lived asset is impaired as a result of damage from a natural disaster or that a receivable from a customer is impaired.

The accounting for insurance claims will vary based on a variety of factors, including the nature of the claim, the amount of proceeds (or anticipated proceeds) and the timing of the loss and recovery. In addition, any accounting for insurance proceeds will be affected by the evaluation of coverage in a given situation as well as an analysis of the ability of an insurer to satisfy a claim.

In the following sections, we discuss the accounting for insurance recoveries for property and casualty losses, business interruption losses and other losses.
Property and casualty

Companies often maintain insurance to mitigate losses associated with property damage. The accounting for the involuntary conversion of nonmonetary assets (such as property or equipment) to monetary assets (such as insurance proceeds) is addressed in ASC 605-40, Revenue Recognition – Gains and Losses. Companies that have adopted ASC 606, Revenue from Contracts with Customers will find the same guidance in ASC 610-30, Revenue Recognition – Other Income – Gains and Losses on Involuntary Conversions.

When a nonmonetary asset is involuntarily converted to a monetary asset, a company must recognize the effects of that conversion, even though it reinvests, or is obligated to reinvest, the monetary assets in a replacement asset. For example, when a building is completely destroyed, the asset must be written off, regardless of whether the insured can recover its losses through an insurance policy and intends to repair or replace the facility. When a nonmonetary asset is destroyed or damaged in one accounting period, and the amount of monetary assets to be received cannot be determined until a subsequent period, the loss is recognized when incurred, notwithstanding the expected insurance recovery. That is, the determination of whether to recognize a loss is made without regard to any expected recoveries from insurance.

The accounting for proceeds from insurance depends on whether the proceeds partially or fully cover or exceed the amount of loss recognized. This is how it works:

- Receipts from insurance up to the amount of the loss recognized are considered recoveries. These recoveries may be accounted for when receiving them is probable.1 Insurance recoveries should not be recognized before the related cost is recognized.

- Anticipated proceeds in excess of the recognized loss are considered a gain and are subject to the guidance in ASC 450-30, Contingencies – Gain Contingencies. Anticipated proceeds in excess of a loss recognized in the financial statements may not be recognized until all contingencies related to the insurance claim are resolved. We believe the contingencies would generally be considered resolved only if the company has received the proceeds or confirmation of the amount of the proceeds from the insurer. The confirmation should be written and indicate: (1) receipt of the insurance claim; (2) the insurance coverage (e.g., the property covered, the amount of that coverage); and (3) that the likelihood of the estimated recovery changing is remote. Documentation from a claim adjuster that includes a specific dollar amount would generally not be considered sufficient evidence to recognize a gain on an insurance recovery.

Insurance recoveries must be accounted for on a property-by-property basis rather than aggregated using a “portfolio” approach.

We believe recoveries related to recognized losses associated with natural disasters are recognized subsequent events that provide additional evidence regarding the amount of loss at the date of the balance sheet and affect the estimates inherent in the process of preparing financial statements. However, gain contingencies subject to ASC 450 (including proceeds in excess of the amount of loss recognized) are not recognized until the period in which all contingencies are resolved, even if resolution occurs after the balance sheet date and before the financial statements are issued or are available to be issued (i.e., gain contingencies are considered non-recognized subsequent events).

How we see it

We believe timely disclosure of an expected recovery is appropriate even when recognition of the gain is deferred until the amount is determinable with certainty. However, as stated in ASC 450-30, care should be taken to avoid disclosures that could be misleading about the amount or likelihood of realizing the potential recovery.
The following illustrations assume the complete destruction of the insured property, but the concepts would also apply to a partial impairment of the insured property.

**Illustration 1 – Fair market value recovery**

Assume that Company A owned real property that is completely destroyed in a natural disaster. The property had a net book value of $100 just before the natural disaster and a fair market value of $130 based on an independent appraisal 18 months before the natural disaster. Also assume that Company A’s insurance policy covers the fair market value of the property.

Company A would recognize a $100 loss on the property in the period the natural disaster occurs. Company A would then recognize a $100 recovery for the incurred loss in the period it believes it is probable the insurance company will settle the claim for at least $100. If the insurer agreed to pay the fair market value stated in the appraisal, Company A would recognize the $30 gain in excess of the loss when it receives the cash proceeds or confirmation of the amount of the proceeds from the insurer.

Because the appraisal indicating that a market value of $130 was stale, Company A would need a fairly high level of evidence to conclude that a recovery of 100% of the loss was probable. If, however, the fair market value was estimated to be more than double the net book value and was based on a recent appraisal, the level of evidence required to conclude recovery of at least the recognized loss would typically be less.

If Company A concludes it has met the recognition criteria for the recovery of the loss after the balance sheet date but before it issues its financial statements, the $100 recovery would be recognized in those financial statements as a recognized subsequent event.

If the cash proceeds or a confirmation is received after the balance sheet date but before the financial statements are issued, the $30 gain is a non-recognized subsequent event that is not pushed back to the yet-to-be-issued financial statements.

**Illustration 2 – Fair market value recovery with deductible**

Assume that the facts in Illustration 1 apply to Company B, but it has a $10 deductible. Company B would recognize the $100 loss on the destroyed property in the period in which the natural disaster occurs. A $90 recovery for the incurred loss would be recognized in the period Company B believes it is probable the insurer will settle the claim based on a value of at least $100. In addition, Company B would carefully analyze the provisions of its insurance policy regarding the deductible and evidence of fair market value of the real property.

If the fair market value is greater than the $100 net book value, a portion of the difference between fair value and net book value may be recognized in the period in which the $100 loss is recognized. That is, if it is clear the insurance recovery will exceed the net book value and the deductible, we believe the recovery attributable to the deductible loss can be recognized. The gain of $20 ($130 fair market value minus the $10 deductible and the $100 net book value), would be deferred until all contingencies related to the gain are resolved (i.e., it would be treated as a non-recognized subsequent event).

Company B must clearly demonstrate that the insurance policy covers the claim and that the insurance carrier will reimburse at least the recognized loss before it can recognize the recovery of the deductible. The level of evidence needed to support the recovery of a deductible is based on the facts and circumstances.
Illustration 3 – Replacement cost recovery

Assume that Company C owned property with a net book value of $100 and fair market value of $120 just before a natural disaster that completely destroys the property. Assume that the expected replacement cost is $150 and that the insurance policy is a “replacement cost” policy (i.e., losses of fair market value are covered upon occurrence, and any costs to replace the property are covered if the property is replaced).

Company C would recognize a $100 loss on the destroyed facility in the period in which the natural disaster occurs. The company would recognize the $100 insurance recovery when it determines it is probable the insurance recovery will equal or exceed the recognized loss. However, the $20 difference between fair market value and net book value would not be recognized as a gain until all contingencies were resolved. If that happened, the $20 gain would be reflected in earnings.

If Company C rebuilds the facility (including improvements or additions to the original structure) and incurs $175 in total costs, the additional insurance recovery of $30 (i.e., replacement cost of $150 less $120 fair market value) would be recognized as a gain in earnings when construction costs are incurred and the insurance recovery for replacement cost is probable.

While these illustrations describe the accounting for insurance recoveries related to asset write-offs or impairments, we believe the concepts would apply to the reimbursement of repair and maintenance costs when an impairment is not triggered and a write-off of an asset is not appropriate. For example, if a company believes it is entitled to a $1,500 insurance reimbursement as a result of damage to an asset that is not impaired but the company has incurred costs of only $1,000 to repair the damage as of year end, the company would consider only the $1,000 due from the insurer a recovery of the loss. The remaining $500 would be considered a gain contingency.

Business interruption

Business interruption policies require careful analysis due to the wide variety of terms and conditions. Many policies cover temporary relocation costs (e.g., duplicate rent) that may be easily quantified after the loss. Others cover lost revenue or operating margins that typically are measured over a longer period and require comparisons with similar periods in prior years. In these cases, no insurance recoveries would be available if revenues or operating margins improved during the measurement period. For example, a retailer may lose an entire month’s revenue but make up those revenues the following quarter, and no insurance recoveries would be available under the policy for lost revenue.

How we see it

We believe recoveries of temporary relocation costs should be treated like recoveries of property and casualty losses. That is, recoveries of costs that have been incurred should be recognized when a company believes it is probable the insurer will settle the claim for at least the amount of the costs incurred to date.

Anticipated reimbursements for lost revenue are considered a gain contingency, and ASC 450-30 requires that all contingencies must be resolved before such a reimbursement can be recognized in earnings. The contingencies would be considered resolved only if the proceeds have been received or if confirmation of the amount of the proceeds has been received from the insurer.
Other

Natural disasters can cause environmental contamination that can trigger a liability for environmental remediation costs. These costs should be recorded in accordance with ASC 410-30, *Asset Retirement and Environmental Obligations – Environmental Obligations*. See the *Asset retirement obligations and environmental costs* section of this publication for a discussion of environmental contamination obligations.

If environmental remediation costs are covered by insurance, the recoveries would be accounted for in accordance with ASC 410-30. An asset relating to the recovery is recognized only when receipt of the insurance proceeds is deemed probable. When that occurs, transaction costs related to the receipt of the recovery and the time value of money should be considered. The time value of money should not be considered if the related liability is not discounted and the timing of the recovery depends on the timing of the payment of the liability. Refer to ASC 410-30, for further guidance.

**Presentation of insurance recoveries on the statement of financial position**

ASC 210-20, *Balance Sheet – Offsetting*, provides guidance on determining whether assets and liabilities can be offset and presented on a net basis. The subtopic states that a right of setoff exists only when all of the following conditions are met:

- Each of the two parties owes the other amounts that can be determined.
- The reporting party has the right to set off the amount owed with the amount owed by the other party.
- The reporting party intends to set off.
- The right of setoff is enforceable at law.

When a company incurs losses associated with a natural disaster, the party that the company owes is typically not the insurer (as is required by the first condition listed above). Even if the first condition were met, it would be rare for a legal right of offset to exist. Therefore, we believe that the requirements of ASC 210-20 would rarely be met for insurance recoveries, and insurance recoveries shouldn't be offset against losses. Instead, the gross amount of insurance recoveries and loss contingencies related to a natural disaster should be presented.

**Classification of insurance proceeds on the statement of cash flows**

ASC 230, *Statement of Cash Flows*, requires proceeds from the settlement of insurance claims (except those related to corporate- or bank-owned life insurance policies) to be classified based on the related insurance coverage (i.e., the nature of the loss). A lump-sum settlement that relates to more than one type of loss should be allocated to each type of loss to determine how the proceeds should be classified. For example, a portion of the proceeds from a lump-sum settlement that relates to the loss of a building in a natural disaster and business interruption costs would be allocated and classified partially as investing and partially as operating activities. Judgment may be required when evaluating the nature of the loss.

**Hedge accounting**

A natural disaster can disrupt business transactions, causing them to be postponed or canceled. For example, companies may have been forecasting purchases of goods or sales of their goods to companies with operations in the affected region. Prior to the disaster, many such transactions may have constituted hedged forecasted transactions in cash flow hedges under ASC 815, *Derivatives and Hedging*. However, purchases and sales that were “probable” a few weeks before a natural disaster may no longer be probable of occurring after a natural disaster. In fact, it may be probable that the forecasted transaction will not occur as discussed in the guidance in ASC 815.

The terms of business interruption policies vary widely and require careful analysis.
Companies should consider the effect of the natural disaster on whether an arrangement qualifies for hedge accounting. A fundamental requirement is that the hedging relationship, both at inception and on an ongoing basis, is expected to be highly effective in offsetting changes in fair value or cash flows attributable to the hedged risk during the period that the hedge is designated. For hedgers that use statistical methods such as regression analyses to assess ongoing qualification for hedge accounting, new data incorporating the effects of the disaster must be added to the regression analyses. While regression analyses often allow aberrant data to be incorporated into a multi-period analysis in a way that helps to preserve hedge accounting, it is possible that the data could be so aberrant as to cause the hedger to conclude that the regression analysis no longer support the use of hedge accounting.

A hedge relationship includes both a derivative and a hedged item or hedged forecasted transaction. Like all external events, the disaster could affect the probability of hedged forecasted transactions occurring at the same time and in the same amounts as designated at the inception of a hedge. Hedgers must evaluate the probability of forecasted transactions occurring to maintain hedge accounting as well as the probability that a forecasted transaction will *not occur* to determine whether to immediately reclassify to earnings balances from past changes in the fair value of derivative contracts that have accumulated in Accumulated Other Comprehensive Income.

If a hedger concludes that hedge accounting is no longer appropriate, we believe the hedger is permitted to identify the specific event or change in circumstances that caused the hedging relationship to fail the effectiveness criteria and to follow hedge accounting up until the precise date of such an event. For certain transactions, that may be the date of the natural disaster.

Additionally, if a company has elected to apply the normal purchases and normal sales (NPNS) scope exception for a contract that would otherwise be accounted for as a derivative under ASC 815, a natural disaster may affect whether the contract will be physically settled. Refer to section 2.5.2.2, *Must not settle net and will result in physical delivery*, of our Financial reporting developments publications, *Derivatives and hedging (before the adoption of ASU 2017-12)*, or *Derivatives and hedging (after the adoption of ASU 2017-12, Targeted Improvements to Accounting for Hedging Activities)*, for guidance on the possible tainting of NPNS designations due to the inability to physically settle.

**Other accounting matters**

### Future operating losses

Companies may incur other losses that are directly or indirectly related to a natural disaster. A company may anticipate having operating losses for a period of time after a natural disaster. For example, a company may have repair costs, loss of future revenues due to plant closures or losses due to an overall decline in the economy. Future operating losses do not meet the definition of a liability and therefore should not be recognized until the losses are incurred.

### Exit or disposal activities

After a natural disaster, a company may decide to sell or abandon certain assets or execute a restructuring plan. ASC 420, *Exit or Disposal Cost Obligations*, addresses the accounting for costs associated with exit or disposal activities. Exit activities may include:

- Sale or termination of a line of business
- Closure of a business location in a country or region or the relocation of business activities from one country or region to another
- Changes in management structure
An event may be considered an exit activity even if it does not have a material effect on an entity’s business or the manner in which that business is conducted.

- Fundamental reorganizations that have a material effect on the nature and focus of a company’s operations

It’s not necessary for an event to have a material effect on an entity’s business or the manner in which that business is conducted to be considered an exit activity. An exit activity can include the decision to move from one facility to another.

Disposal activities include disposals by sale or other means (e.g., by abandonment, exchange for other assets or a group of assets, distributions to owners in a spin-off, other forms of reorganization or liquidation). The impairment of long-lived assets being disposed of is addressed in ASC 360-10, as discussed previously.

The costs often incurred as part of an exit or disposal activity include employee termination benefits under a one-time termination plan, contract termination costs and costs to consolidate or close a facility and relocate employees. A liability for costs associated with an exit or disposal activity is recognized at fair value in the period the liability is incurred. For example, a liability to terminate a contract before the end of its term is recognized when the entity terminates the contract.

Before the adoption ASC 842, a liability for costs that will continue to be incurred under an operating lease for its remaining term without economic benefit to the entity should be recognized and measured at its fair value when the entity ceases using the right conveyed by the lease. After the adoption of ASC 842, ASC 420 is amended to exclude costs to terminate a contract that is a lease from the scope of that guidance. Therefore, when a company ceases to use an asset being leased, it will evaluate the recognized right-of-use asset for impairment in accordance with ASC 360.

**How we see it**

While ASC 842 excludes costs to terminate a contract that is a lease from the scope of ASC 420, the amended guidance in ASC 420 does not specify whether the non-lease component in a contract that contains both a lease and a non-lease component is subject to ASC 420.

A lessee that makes the policy election to account for a lease component of a contract and its associated non-lease components as a single lease component would allocate all of the contract consideration to the lease component. That is, in this situation, a lessee would not apply ASC 420 to the contract because leases are excluded from the scope of ASC 420.

However, a lessee that does not make the policy election to combine the lease and associated non-lease components follows the guidance in ASC 842 to account for the lease component and other applicable guidance to account for the non-lease component. As such, we believe lessees should consider the guidance in ASC 420 for exit or disposal costs associated with the non-lease component(s).

The costs associated with temporarily vacating a facility would not be subject to ASC 420. An evaluation of whether an entity has ceased using a facility permanently or temporarily is based on the facts and circumstances.

Costs associated with one-time employee termination benefits are measured at the time employees receive communication of the termination and are either recognized on the communication date or over the service period, depending on whether future services are required. A liability for costs associated with closing a facility and relocating employees is not recorded until the associated costs are incurred.
Refer to our Financial reporting developments publication, *Exit or disposal cost obligations*, for additional information.

**Asset retirement obligations and environmental costs**

Companies should consider the effect a natural disaster may have on any asset retirement obligations and whether a liability has arisen related to any pollution and/or other environmental issues.

ASC 410-20, *Asset Retirement and Environmental Obligations – Asset Retirement Obligations* applies to AROs, legal obligations associated with the retirement of a tangible long-lived asset that can result from:

- A government action, such as a law, statute or ordinance
- An agreement between entities
- A promise to a third party that imposes a reasonable expectation of performance under promissory estoppels

If a company determines that a modification to an ARO is necessary due to changes in the estimate of the timing or amount of cash flows required to settle the obligation, the adjustment would be recorded by increasing or decreasing the related property's carrying value and increasing or decreasing the ARO liability. However, downward revisions should not reduce the carrying amount of the underlying asset (including depreciation and the ARO asset) below zero. Therefore, a downward revision that is greater than the carrying amount would result in a profit and loss effect.

Upward revisions in the amount of estimated cash flows required should be discounted using the credit-adjusted risk-free rate in effect at the time of the revision. Downward revisions in estimated cash flows should be discounted at the rate that was used when the original liability was recognized. While ASC 410-20 is not clear on the rate that should be used for revisions related to a change in the estimated timing of settlement of the obligation, we believe the credit-adjusted risk-free rate in effect at the time of the change in estimate should be used. However, it may also be acceptable to use the rate in effect at the time the liability was first recognized. Refer to our Financial reporting developments publication, *Asset retirement obligations*, for additional information.

The guidance for accounting for environmental liabilities is provided in ASC 410-30, which applies to all operations of an entity subject to environmental laws. The guidance does not apply to AROs or environmental remediation actions that are undertaken at the sole discretion of management, without the threat or assertion of litigation, a claim or an assessment. A liability for an environmental obligation must be recognized when it is probable that a loss has been incurred and the amount of the loss can be reasonably estimated. ASC 410-30 provides considerations for evaluating the probability that a loss has been incurred and the extent to which the amount of any loss can be reasonably estimated.

A remediation liability should be measured based on available information and should include incremental direct costs of the remediation effort and costs of compensation and benefits for employees who are expected to devote a significant amount of time directly to the remediation effort. Companies can elect to accrue expected legal defense costs associated with the liability as an accounting policy, but this treatment is not required.

Physical repairs to structures that are not required by regulatory or other legal obligations would not be subject to the guidance in ASC 410-20 or 410-30 and would be recognized as obligations once the work is contracted and costs are incurred.
Financial statement disclosure requirements

The financial statement disclosure for companies directly and/or indirectly affected by a natural disaster will vary depending on the magnitude of their losses and the availability of information. In many cases, the financial statement disclosure requirements are addressed based on the nature of the loss (e.g., asset impairments). In other cases, the financial statement disclosure requirements are generally addressed as loss contingencies, risks and uncertainties and/or subsequent events. The following discussion provides a brief summary of those financial statement disclosures.

Loss contingencies

ASC 450 requires disclosure of the nature of a contingency when there is at least a reasonable possibility that a loss has been incurred. For contingencies that meet the threshold for disclosure but where no liability has been recognized, companies must disclose an estimate of the possible loss or the range of possible losses or state that such an estimate cannot be made. If a liability has been recognized, the amount has to be disclosed only if not doing so would make the financial statements misleading. If there is at least a reasonable possibility that a loss in excess of the amount recognized exists, the company is required to disclose an estimate of the possible loss or range of losses or state that such an estimate cannot be made.

How we see it

Loss contingency disclosures have been an area of focus for the SEC staff. The SEC staff focuses on disclosures about reasonably possible losses and the clarity and timeliness of loss contingency disclosures.

Specifically, the SEC staff has questioned a company’s failure to make required footnote disclosures when losses are considered reasonably possible of occurring or to disclose the range of reasonably possible losses, including when there is a reasonable possibility of a loss in excess of the amount accrued.

Risks and uncertainties

ASC 275 requires disclosures about certain risks and uncertainties. They include qualitative disclosures about risks and uncertainties that in the near term (i.e., within one year from the date of the financial statements) could significantly affect the amounts reported in the financial statements or the functioning of the reporting entity. Companies affected both directly and indirectly by a natural disaster may be required under ASC 275 to disclose certain significant estimates and current vulnerability due to concentrations (e.g., concentration in the volume of business with a particular customer).

Certain significant estimates

Disclosure of certain change-sensitive estimates, such as estimates involved in evaluating an asset for impairment, should be made if information known to management before the financial statements are issued or available to be issued meets both of the following criteria:

- It is at least reasonably possible that management’s estimate of the effect on the financial statements of a condition, situation or set of circumstances existing at the date of the financial statements will change in the near term as a result of one or more future confirming events.
- The effect of the change would be material to the financial statements.
The objective of this disclosure is to provide an early-warning signal regarding the possibility that certain estimates made by management in preparing the financial statements may change in the near term. Public companies have a similar responsibility under SEC requirements to discuss in management’s discussion and analysis known material events and uncertainties that may make historical financial information not indicative of future operations or financial condition.

For uncertainties that meet both of ASC 275’s criteria for disclosure, entities are required to state the nature of the contingency or change-sensitive estimate and indicate that it is reasonably possible that a change in the estimate will occur in the near term. Additionally, ASC 275 encourages, but does not require, disclosure of the factors that cause an estimate to be sensitive to material change.

If an entity’s use of risk-reduction techniques (such as obtaining insurance) causes an uncertainty to not meet the criteria for disclosure, ASC 275 encourages, but does not require, disclosure of the uncertainty along with the related risk-reduction strategy.

**Current vulnerability due to certain concentrations**

Companies with concentrations face greater risks of losses than companies that are diversified. ASC 275 requires disclosure of certain concentrations, as described in ASC 275-10-50-18, if, based on information known to management before the financial statements are issued or available to be issued, all three of the following criteria are met:

- The concentration exists at the date of the financial statements.
- The concentration makes the entity vulnerable to the risk of a near-term “severe impact.”
- It is at least reasonably possible that events that could cause the severe impact will occur in the near term.

Companies that have identified concentrations in activities in the areas affected by a recent natural disaster (e.g., concentrations in the volume of business with customers in that area) that have not previously disclosed the concentration because they did not believe the company was vulnerable to the risk of a near-term severe impact should reconsider those disclosure requirements.

When the criteria for disclosure are met, the company should provide information that is adequate to inform users of the financial statements of the general nature of the risks or uncertainties associated with the concentration. For concentrations of foreign operations, an entity is required to disclose both the carrying amount of net assets and the geographic areas in which they are located.

**Going concern**

ASC 205-40, *Presentation of Financial Statements – Going Concern*, requires management to evaluate an entity’s ability to continue as a going concern within one year after the date the financial statements are issued (or available to be issued, when applicable). Disclosures in the notes to the financial statements are required if management concludes that substantial doubt exists or that its plans alleviate substantial doubt that was raised. Management is required to make its evaluation and provide the relevant disclosures for both annual and interim reporting periods.

Companies will need to consider the effects of a natural disaster in their going concern evaluations. For example, damage to a manufacturing facility may significantly affect a company’s operating cash flow. Accordingly, management may need to update the cash flow projections used in its going concern evaluation.
Subsequent events
Companies affected by a natural disaster that occurred after the balance sheet date but before the financial statements are issued or available to be issued should consider disclosing the nature of the event and an estimate of its effect on the financial statements, or a statement that such an estimate cannot be made. Additionally, companies that may be indirectly affected by the event, such as a company with a concentration of revenue from customers in the affected area, should consider whether subsequent event disclosures are necessary to keep the financial statements from being misleading.

SEC reporting and interim disclosures
A natural disaster also may trigger a number of SEC reporting and disclosure requirements.

Form 8-K reporting obligations
Companies should consider the direct and/or indirect effects of a natural disaster on their reporting obligations on Form 8-K. As previously discussed, interim impairment tests may result in impairment charges as a result of a natural disaster.

As a reminder, Item 2.06 of Form 8-K requires certain disclosures when a company concludes that it will record a material impairment charge. If the amount of impairment has not been determined at the time of the Form 8-K, the company must disclose an estimate or range. If an estimate or range cannot be determined in good faith, the company must amend the Form 8-K within four business days of making such a determination. Such disclosure is not required in the Form 8-K if the company reaches, and discloses, this conclusion in connection with the preparation of its financial statements required to be included in its next Form 10-Q, as long as the Form 10-Q is timely filed.

Companies also should consider their reporting obligations under other sections of Form 8-K, such as Item 2.04, Triggering Events that Accelerate or Increase a Direct Financial Obligation or an Obligation under an Off-Balance Sheet Arrangement, and Item 8.01, Other Events.

Management's discussion and analysis
When discussing the results of operations for the period, companies should clearly disclose any significant effect on income from continuing operations related to a natural disaster such as lost revenues or costs attributable to the event.

Companies should consider providing summarized financial information (i.e., balance sheet and income statement) for any subsidiaries for which the effects of the natural disaster are material to the consolidated operations or are reasonably expected to materially affect the company in future periods. In considering materiality, companies should be mindful of the negative effects at operations that historically haven't been significant to the consolidated entity.

The discussion should also provide forward-looking information about any material trends and uncertainties related to a company’s liquidity and capital resources and results of operations. As an example, these disclosures might include a discussion of any risk of impairment, other charges not yet recognized or financial commitments or obligations that could affect a company’s liquidity. They might also include disclosure of any expected changes in business practices that will affect operations and liquidity, including situations in which the relationship between costs and revenues could be materially affected.
Non-GAAP financial measures
Companies should be mindful of the SEC's rules and regulations regarding the use of non-GAAP financial measures and the SEC staff Compliance and Disclosure Interpretations on the use of these measures. For example, it may be appropriate to disclose a non-GAAP measure that adjusts for certain non-material costs related to a natural disaster. Such costs can only be described as non-recurring if they have not occurred within the most recent two years and are not expected to recur within the following two years. It would be inappropriate to disclose a historical non-GAAP measure of operating performance that adds to net income an estimate of revenues lost as a result of the natural disaster.

Risk factor disclosures
Companies should consider updating their risk factor disclosures in Item 1A of Form 10-Q if there have been material changes or new risk factors resulting from a natural disaster in an interim period.

Other
Companies may need to consider providing disclosures in other areas of the periodic reports and registration statements, including the description of the business and properties under Items 101 and 102 of Regulation S-K, respectively.

Finally, the disruption of a natural disaster could affect a registrant's ability to timely file or comply with other regulatory requirements. The SEC staff has provided relief to companies affected by certain natural disasters. Companies affected by a natural disaster should contact the SEC staff if they believe that their circumstances warrant relief from filing deadlines and other regulatory requirements.2

Endnotes:
1 Probable is defined in the ASC Master Glossary as “the future event or events are likely to occur.”