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Financial Reporting Implications of Disasters

This *Financial Reporting Alert* has been revised to reflect an update related to the SEC's September 28, 2017, announcement that it is providing certain regulatory relief to publicly traded companies, investment companies, accountants, transfer agents, municipal advisers, and others affected by Hurricanes Harvey, Irma, and Maria (see the discussion in the [SEC Relief](#) section below).

Background

This *Financial Reporting Alert* highlights some of the financial reporting implications of disasters for entities reporting under U.S. GAAP. North America has been affected by a series of natural disasters in recent weeks, including Hurricanes Harvey, Irma, and Maria, and two significant earthquakes that struck Mexico within a span of 12 days. Disasters can also take other forms, such as the September 2001 terrorist attacks on the World Trade Center in New York and the Pentagon outside Washington, D.C.

In addition to tragic loss of life, disasters can cause widespread damage and destruction of property and varying degrees of business activity disruption in affected regions and, in some cases, other areas of the world. Some entities may have principal operations in the affected area, while others may have ancillary operations or interests in the affected region. Other entities may be affected as a result of relationships with major suppliers physically located in the affected region. In addition, insurance entities may experience significant losses as a result of a disaster.

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A number of financial reporting implications can arise as a result of a disaster. Such implications can include the accounting for asset impairments, income statement classification of losses, insurance recoveries, and additional exposure to environmental remediation liabilities. This *Financial Reporting Alert* identifies potential implications and applicable authoritative guidance. The financial reporting implications discussed in this *Financial Reporting Alert* are not intended to be all-inclusive but as a starting point for thinking about the issues that might arise.

Asset Impairments

A disaster can result in the impairment of assets. The analysis of whether a disaster results in an impairment (and the resulting measurement of impairment) is often difficult after a disaster because there may be many uncertainties about the prospects of the asset (or group of assets). Entities should consider the guidance below in performing their impairment assessments.

Long-Lived Assets

U.S. GAAP on property, plant, and equipment and the impairment or disposal of long-lived assets in ASC 360¹ requires entities to test a long-lived asset or group of assets for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable (see ASC 360-10-35-21). For example, the impact of a disaster may cause entities to assess the recoverability of long-lived assets in accordance with ASC 360-10-35-21 because there may be any of the following:

- “A significant decrease in the market price of a long-lived asset (asset group).”
- “A significant adverse change in the extent or manner in which a long-lived asset (asset group) is being used or in its physical condition.”
- “A current expectation that, more likely than not, a long-lived asset (asset group) will be sold or otherwise disposed of significantly before the end of its previously estimated useful life.”
- A significant decline in the asset’s (or asset group’s) capacity to generate income or cash flows such that forecasts demonstrate continuing losses.

ASC 360 requires that entities group long-lived assets to be held and used for impairment testing at the lowest level for which identifiable cash flows are largely independent of cash flows of other assets and liabilities (see definition of asset group in ASC 360). If the long-lived asset group is not deemed recoverable, an impairment loss is measured as the amount by which the carrying amount of the asset group exceeds its fair value (see ASC 360-10-35-17).

In some cases, entities may conclude that long-lived assets affected by a disaster will be disposed of by sale or abandonment. When the “held for sale” criteria in ASC 360-10-45-9 through 45-11 are met, entities are required to recognize a loss for any initial or subsequent write-down of the disposal group to fair value less costs to sell. Long-lived assets to be disposed of by abandonment should continue to be classified as held and used until disposed of with recoverability testing as described above.

If the disaster occurs near the end of the next financial reporting period, it may create challenges for entities when they are assessing their plans for the affected assets (e.g., repair and return to service, hold for sale, abandon) as well as the related cash flow effects of each plan.

¹ For titles of FASB Accounting Standards Codification (ASC) references, see Deloitte’s “Titles of Topics and Subtopics in the FASB Accounting Standards Codification.”

Finite-Lived Intangibles

The impact of a disaster may trigger the need to test an entity's finite-lived intangibles (e.g., customer relationships, patents, copyrights) for impairment. Entities should apply the recognition and measurement provisions in ASC 360-10-35-17 through 35-35 when reviewing finite-lived intangibles for impairment (see ASC 350-30-35-14). Thus, the analysis of finite-lived intangibles is not different from the analysis of long-lived assets discussed above.

Indefinite-Lived Intangibles Other Than Goodwill

An intangible asset that is not subject to amortization should be tested for impairment annually or more frequently when an event or change in circumstances indicates that it is more likely than not that the asset is impaired. The impact of the disaster may necessitate the testing of one or more indefinite-lived intangibles for impairment. The impairment test would consist of a comparison of the fair value of an intangible asset with its carrying amount, and an impairment would be recognized for the amount, if any, by which the carrying amount exceeds the fair value.



Connecting the Dots

After the adoption of ASU 2012-02,² an intangible asset that is not subject to amortization must be tested for impairment annually and more frequently if events or changes in circumstances indicate that it is more likely than not that the asset is impaired (i.e., that the carrying amount exceeds the fair value). The ASU indicates that an entity may first perform a qualitative assessment to determine whether it is necessary to perform the quantitative impairment test described in ASC 350-30-35-19. An entity has an unconditional option to bypass the qualitative assessment for any indefinite-lived intangible asset in any period and proceed directly to performing the quantitative impairment test. ASC 350-30-35-18B contains examples of events and circumstances that an entity should consider in assessing whether it is more likely than not that the indefinite-lived intangible asset is impaired. These examples are similar to those in ASC 360-10-35-21.

Goodwill

As a result of the destruction and loss of business caused by a disaster, an entity may need to test goodwill for impairment. Entities are required to test goodwill for impairment annually or more frequently in certain circumstances (this requirement is similar to the guidance on other indefinite-lived intangibles and includes an optional qualitative assessment). Specifically, an entity should test goodwill for impairment when an "event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount."

Inventory Impairments

A disaster may lead to circumstances in which the utility of inventory on hand is impaired by damage, deterioration, obsolescence, changes in price levels, or other causes. Whether the impairment is caused by physical destruction or an adverse change in the utility of the inventory, entities should assess whether an inventory impairment or write-off is required in accordance with ASC 330-10-35-1A through 35-11 as appropriate, which address adjustments of inventory balances to the lower of cost or market.

Entities may also need to expense, in the period in which it is incurred, fixed overhead that is not allocated to inventory because it results from abnormally low production or an idle plant. Other items such as abnormal freight, handling costs, and amounts of wasted materials (spoilage) must be treated as current-period charges rather than as a portion of the inventory cost (see ASC 330-10).

² FASB Accounting Standards Update (ASU) No. 2012-02, *Testing Indefinite-Lived Intangible Assets for Impairment*.

Receivables

Receivables from entities affected by a disaster should be evaluated for collectibility. Entities may incur additional write-offs of receivables deemed uncollectible or may be required to establish additional reserves on receivables.

Loans

Creditors are required to evaluate loans for collectibility and assess whether a loan is impaired, which occurs when, on the basis of 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 (see ASC 310-10-35-16). In a disaster event, debtors experiencing operational declines, especially declines in cash flows and liquidity, may not be able to make principal and interest payments in a timely manner. This may lead to impairment of such loans on the creditor's books, because it may become probable that contractually specified cash flows will not be collected.

If the creditor modifies the terms of a loan because of a disaster, it should consider whether the modification is a troubled debt restructuring (see ASC 310-40). A loan that is a troubled debt restructuring is an impaired loan, and the measurement of impairment is discussed in ASC 310-10-35-20 through 35-32.

Equity Method Investments and Investments in Debt and Equity Securities

Declines in the market value of securities or impairments as a result of defaults, bankruptcy, or both should be considered in the evaluation of whether investments are other-than-temporarily impaired. ASC 320-10-35-17 through 35-37 and SEC Staff Accounting Bulletin Topic 5.M, "Other Than Temporary Impairment of Certain Investments in Equity Securities," provide guidance on evaluating whether an impairment is other than temporary.

Income Statement Classification of Losses

A common financial reporting consideration when a disaster strikes is whether the resulting losses should be reported or disclosed in the financial statements as a separate component of income from continuing operations.

In situations in which it is concluded that a material event or transaction is unusual in nature or occurs infrequently (or both), ASC 225-20-45-16 requires that such an event or transaction "be reported as a separate component of income from continuing operations." Further, ASC 225-20-45-16 notes that for each such event or transaction, an entity must report the nature and financial effects as a separate component of income from continuing operations or, alternatively, disclose them in the notes to the financial statements.

In assessing whether a natural disaster meets the definition of "unusual nature" or "infrequency of occurrence" for financial reporting purposes, an entity would need to consider the environment in which it operates, thereby limiting the scope of events or transactions that would qualify.

ASC 225-20-20 defines "unusual nature" as situations in which "[t]he underlying event or transaction [possesses] a high degree of abnormality and [is] of a type clearly unrelated to, or only incidentally related to, the ordinary and typical activities of the entity, taking into account the environment in which the entity operates."

Similarly, ASC 225-20-20 defines "infrequency of occurrence" as an "underlying event or transaction [that is] of a type that would not reasonably be expected to recur in the foreseeable future, taking into account the environment in which the entity operates."

Accordingly, an entity would need to perform a thorough evaluation of factors associated with its operating environment, including its industry and geographical location, to determine whether the event is unusual as well as the probability of its recurrence. An entity's assessment of the probability of recurrence must, at all times, be based on the particular set of facts and circumstances at the time of the event's or transaction's occurrence.



Connecting the Dots

While the guidance previously found in the AICPA Technical Practice Aids, TIS Section 5400.05, "Accounting and Disclosures Guidance for Losses From Natural Disasters — Nongovernmental Entities," was deleted because of the FASB's issuance of ASU 2015-01,³ we believe that the following excerpt from the AICPA TPA TIS Section 5400.05 is useful because it observed that the magnitude of a loss from a natural disaster is not a determining factor when an entity is assessing whether such losses are unusual in nature or unlikely to recur:

The magnitude of loss from a particular natural disaster does not cause that disaster to be unusual in nature or unlikely to reoccur. If losses from such natural disasters meet the criteria for disclosure of unusual or infrequently occurring items in FASB ASC 225-20-45-16, they should be reported as a separate component of income from continuing operations either on the face of the statement of operations or in the notes to the financial statements. [Emphasis added]

Overview of Insurance Analysis

Assessing the extent to which insurance coverage exists may be challenging and require the assistance of an entity's legal counsel. In determining the accounting for insurance recoveries, an entity should first perform an assessment similar to the following:

- Does the entity have insurance, and is the specific loss insured? The entity should consider whether "insurance" actually exists and whether the specific events are covered. For example, as discussed below, an entity may have finite insurance that does not necessarily transfer significant insurance risk.
- Will there be disputes over the cause and extent of the damage? In determining the amount of expected insurance recoveries to recognize, an entity should consider the potential for disputes with the insurance company and its likelihood of prevailing.
- What is the financial viability of the insurance company? Before recording an insurance receivable, entities should consider the insurer's ability to pay. Entities can look to the following in making that assessment:
 - Quarterly and annual statutory filings. A first step is to consider whether the insurer's surplus/capital is large enough to cover estimated losses. Another factor to consider is how much of the insurer's business is located in an affected region.
 - An entity's insurance broker (if applicable) or a rating agency may have already performed these assessments and may be able to provide additional information.
 - Insurance entity ratings can also be obtained from major rating agencies, including Moody's Investors Service (for financial strength), Fitch (for claims-paying ability), Standard & Poor's (for claims-paying ability), and A.M. Best (for financial strength).

Potential Insurance Claims Disputes

In some cases, not all losses from a disaster may be covered by the insurance policy. For example, many insurance policies written in the United States exclude coverage for flood damage. Therefore, claims for insurance recoveries may be disputed if insured entities and their insurers differ in their assessments of how much of the damage was due to wind versus

³ FASB Accounting Standards Update (ASU) No. 2015-01, *Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items*.

flooding. Also, disputes may arise regarding whether coverage even exists for the losses incurred. Finally, disputes may arise regarding who is responsible for the insurance claims. Estimates of expected insurance recoveries must therefore take into account whether (or how much of) the claim will even be allowed.

Potential for the Insured to Fund Losses of the Insurance Company

In some cases, insurance coverage may not be sufficient to cover the entire amount of repairs required or asset impairments incurred. In addition, depending on the type of insurance coverage, entities may be required to contribute additional premiums. This requirement may even extend to entities not directly affected by the disaster.

Finite Insurance

Under certain finite insurance contracts, an entity pays a premium, approximating the amount of expected losses, into an account held with the insurer. If the cost of losses turns out to be less than the premium, the carrier gives back the difference to the insured; if the losses turn out to be greater, the insured pays an additional premium to the insurer. The main advantage of these types of finite insurance contracts is the transfer of timing risk and not necessarily underwriting risk.

In April 2005, the AICPA issued Technical Practice Aids, TIS Section 1200.06, "Note to TIS Section 1200.07 to 1200.16 — Accounting by Noninsurance Enterprises for Property and Casualty Insurance Arrangements That Limit Insurance Risk," which helps entities identify features indicating that risk may not have been transferred.

If risk has not been transferred, the entity should apply the deposit method outlined in ASC 340-30, which addresses accounting for insurance contracts that do not transfer insurance risk.

Even in cases in which risk has been transferred, an entity may still be required to pay additional premiums on the basis of contractual obligations stated in the policy. Therefore, even though the entity has "insurance," it may still be required to pay back proceeds or pay additional premiums. In those cases, entities should apply the accounting for multiple-year retrospectively rated contracts, as detailed in ASC 720-20. Such accounting is discussed in further detail below.

Retrospectively Rated Insurance Contracts

Retrospectively rated insurance contracts provide for changes in future contractual cash flows (including premium or settlement adjustments) or changes in the contract's future coverage on the basis of contract experience. A critical feature of such contracts is that part or all of the retrospective rating provision is obligatory; thus, the retrospective rating provision creates for each party to the contract future rights and obligations as a result of past events. As detailed in ASC 720-20-25-15, an insured should recognize "a liability to the extent that [it] has an obligation to pay cash (or other consideration) to the insurer that would not have been required absent experience under the contract." Significant damages caused by an unforeseen event, such as a disaster, may indicate that a liability has been incurred under retrospective rating provisions. Similar issues should be considered for single-year retrospectively rated insurance contracts with respect to interim reporting periods.

Mutual Insurance Companies

In a mutual insurance company, the members pay premiums that are pooled to cover the losses incurred by all members of the mutual company. If the mutual company is required to cover large, unexpected losses, it may demand additional premiums from all members or it may increase premiums over subsequent years. By analogy to ASC 720-20-25-15, entities

with a contractual obligation requiring the insured to pay the additional premiums, even if the policy is canceled, have most likely incurred a liability that should be recognized. Therefore, entities not directly affected by an event may be indirectly affected by the requirement to recognize a contractual obligation for additional premiums.

ASC 450, ASC 460, and the guidance on accounting for multiple-year retrospectively rated contracts in ASC 720-20 are additional sources of authoritative literature on assessing whether entities should recognize an obligation for additional premiums.

Insurance Recoveries

ASC 605-40 provides guidance on insurance recoveries.

Classification of Insurance Recoveries

ASC 605-40 provides guidance on the accounting for involuntary conversions of nonmonetary assets (such as property or equipment) to monetary assets (such as insurance proceeds). This guidance requires recognition of a gain or loss on an involuntary conversion of a nonmonetary asset to a monetary asset that is measured as the difference between the carrying amount of the nonmonetary asset and the amount of monetary assets received. An involuntary conversion is considered to have occurred even if an entity reinvests or is obligated to reinvest the monetary assets in replacement nonmonetary assets. Insurance recoveries, including resulting gains and losses, should be classified in a manner consistent with the related losses (i.e., generally within income from continuing operations).

ASC 410-30 provides guidance on the income statement display of environmental remediation costs and related recoveries (such as insurance recoveries). ASC 410-30-45-4 states that “environmental remediation-related expenses shall be reported as a component of operating income in income statements that classify items as operating or nonoperating. Credits arising from recoveries of environmental losses from other parties shall be reflected in the same income statement line.”

Timing of Recognition of Insurance Recoveries

With respect to the timing of recognition of insurance recoveries, an entity should apply ASC 450-30-25-1 and AICPA Technical Practice Aids, TIS Section 5100.35, “Involuntary Conversion: Recognition of Gain,” for recoveries in connection with property and casualty losses; the entity should apply ASC 410-30-35-7 through 35-12 for recoveries in connection with environmental obligations. In general, insurance recoveries that will result in a gain should not be recognized until realized.



Connecting the Dots

Before recording an insurance recovery, entities should consider, among other factors, if such a claim is the subject of a dispute or litigation. Specifically, ASC 410-30-35-9 notes the following:

If the claim is the subject of litigation, a rebuttable presumption exists that realization of the claim is not probable.

In addition, similar guidance in SEC Staff Accounting Bulletin Topic 5.Y, “Accounting and Disclosures Relating to Loss Contingencies” (reproduced in ASC 450-20-S99-1), states, in part:

The staff believes there is a rebuttable presumption that no asset should be recognized for a claim for recovery from a party that is asserting that it is not liable to indemnify the registrant. Registrants that overcome that presumption should disclose the amount of recorded recoveries that are being contested and discuss the reasons for concluding that the amounts are probable of recovery.

Business Interruption Insurance Recoveries

Business interruption insurance differs from other types of insurance coverage in that it is designed to protect the prospective earnings or profits of the insured entity. That is, business interruption insurance provides coverage if business operations are suspended because of the loss of use of property and equipment resulting from a covered loss. Business interruption insurance coverage also generally provides for reimbursement of certain costs and losses incurred during the reasonable period needed to rebuild, repair, or replace the damaged property. Certain fixed costs incurred during the interruption period may be analogous to losses from property damage and, accordingly, it may be appropriate to record a receivable for amounts whose recovery is considered probable. We encourage entities to consult with their independent auditors in connection with their evaluation of whether a receivable may be recorded for expected insurance recoveries associated with fixed costs incurred during the interruption period. Lost revenues or profit margin are considered a gain contingency and should be recognized when earned and realized. Because of the complex and uncertain nature of the settlement negotiations process, this generally occurs at the time of final settlement or when nonrefundable cash advances are made.

ASC 225-30-45-1 covers other income statement presentation matters related to business interruption insurance and allows an entity to “choose how to classify business interruption insurance recoveries in the statement of operations, as long as that classification is not contrary to existing [U.S. GAAP].”

Balance Sheet Presentation of Insurance Recoverables

An entity that purchases insurance from a third-party insurer generally remains primarily obligated for insured liabilities; however, the entity should carefully evaluate the insurance contract and applicable laws. Under U.S. GAAP, claim liabilities should not be presented in the balance sheet net of related insurance recoveries unless the requirements of ASC 210-20 are met. The general principle of that guidance is that net presentation (“offsetting”) of assets and liabilities is appropriate only when a right of setoff exists. ASC 210-20-45-1 states that a right of setoff exists when the following four conditions are met:

- a. Each of two parties owes the other determinable amounts.
- b. The reporting party has the right to set off the amount owed with the amount owed by the other party.
- c. The reporting party intends to set off.
- d. The right of setoff is enforceable at law.

Therefore, in most situations, a right of setoff would not exist under ASC 210-20 because any insurance receivable and claim liability would be with different counterparties (i.e., the insurer and the plaintiff). Entities should also carefully evaluate the balance sheet presentation of similar contingent liabilities with related insurance recoveries. Under ASC 210-20, the offsetting of conditional or unconditional liabilities with anticipated insurance recoveries from third parties is not permissible.

Classification of Insurance Recoveries in the Statement of Cash Flows

ASC 230-10-45-16(c) indicates that proceeds of insurance settlements should be classified as operating cash flows except for recoveries “that are directly related to investing or financing activities, such as from destruction of a building.”

In August 2016, the FASB issued ASU 2016-15,⁴ which amends certain topics in ASC 230. The ASU will be effective for public business entities in fiscal years beginning after December 15, 2017 (and a year later for entities that are not public business entities). However, entities may early adopt the ASU as long as they adopt all of the ASU’s amendments.

⁴ FASB Accounting Standards Update (ASU) No. 2016-15, *Classification of Certain Cash Receipts and Cash Payments* — a consensus of the FASB Emerging Issues Task Force.

ASU 2016-15 clarifies the guidance on insurance claims by deleting the above text from ASC 230-10-45-16(c) and adding ASC 230-10-45-21B, which states that “[c]ash receipts resulting from the settlement of insurance claims, excluding proceeds received from corporate-owned life insurance policies and bank-owned life insurance policies, shall be classified on the basis of the related insurance coverage (that is, the nature of the loss).” In addition, for lump-sum settlements, “an entity shall determine the classification on the basis of the nature of each loss included in the settlement.” The purpose of such clarifications is to provide financial statement users with more relevant information.

For example, insurance settlement proceeds received as a result of a claim made in connection with the destruction of productive assets should be classified as cash inflows from investing activities because the settlement proceeds could be analogous to proceeds received on the sale of such assets. However, proceeds received as a result of claims related to a business interruption should be classified as operating activities.

Sales of Held-to-Maturity Securities

To compensate for decreased cash flows resulting from a disaster, entities may choose to sell their held-to-maturity securities. Typically, a sale of a held-to-maturity security calls into question (taints) the entity's intent to hold other debt securities to maturity in the future. However, ASC 320-10-25-9 states that events that are isolated, nonrecurring, and unusual for the reporting entity, and that could not have been reasonably anticipated, “may cause the entity to sell or transfer a held-to-maturity security without necessarily calling into question (tainting) its intent to hold other debt securities to maturity.” Sales of held-to-maturity securities that are attributable to a disaster may qualify for this exception.

Environmental Remediation Liabilities, Clean-Up Costs, and Future Operating Losses

Environmental Remediation Liabilities

Some past disasters have caused natural gas leaks and leaks from oil storage tanks, damage to underground containers holding potentially toxic materials, and other environmental damage. Entities should assess whether the damage results in additional exposure to environmental remediation liabilities. ASC 410-30-25 provides guidance on recognizing environmental remediation liabilities.

Clean-Up Costs

Not all clean-up costs will represent an environmental remediation liability or have to be accrued. ASC 410-30-25-1 refers to ASC 450, which clarifies that a liability would be recognized when evidence indicates that a liability has been incurred as of the date of the financial statements and the amount of this liability can be reasonably estimated. Given the nature of environmental remediation obligations, the “probable” criteria triggering recognition are presumed to have been met when (1) litigation has commenced or a claim or an assessment has been asserted on or before the balance sheet date or (2) commencement of litigation or assertion of a claim or an assessment is probable on the basis of available information (see ASC 410-30-25-4(a)) and it is probable that this litigation, claim, or assessment will be unfavorable (see ASC 410-30-25-4(b)). Making such a determination in light of the uncertainty that is often associated with a disaster may be extremely difficult. In addition, rubble of damaged buildings and equipment or leaked toxins may never result in litigation or another remediation liability under a law or statute. Clean-up costs, other than those that create an obligation in accordance with ASC 410-30 or that result in other litigation requiring an accrual in accordance with ASC 450, should not be recorded until incurred (i.e., when the clean-up takes place), even though such expenses could be triggered by the disaster event.

Future Operating Losses

An entity may forecast operating losses for a certain period after a disaster. Such losses may result from clean-up and repair costs directly attributable to the event. Other losses may be indirectly related to the event, such as those resulting from declines in customer demand or disruptions in the supply chain. Future operating losses do not meet the definition of a liability, nor do they qualify for accrual under ASC 410-30 or ASC 450. Such losses should be reflected in the period in which the related costs are incurred.

Stock Compensation Performance Conditions and Modifications

Many businesses will cease operations or operate at reduced capacity while recovering from a disaster, which could affect the probability of achieving performance targets for share-based payments with performance conditions. ASC 718-10-25-20 states that “[a]ccruals of compensation cost for an award with a performance condition shall be based on the probable outcome of that performance condition — compensation cost . . . shall not be accrued if it is not probable that the performance condition will be achieved.” For example, if an award contains a performance condition affecting vesting and it is not probable that the performance condition will be met, any previously recognized compensation cost should be reversed.

In addition, entities may decide to change the terms or conditions of an equity award. Unless the fair-value-based measure, vesting conditions, and classification of the award are the same immediately before and after the change, the modification is treated as an exchange of the original award for a new award. If the original award’s vesting was probable, the modification may result in additional compensation cost for any incremental value provided. If the original award’s vesting was not probable, any compensation cost recognized is based on the revised fair-value-based measure as of the modification date. Entities should account for these modifications in accordance with ASC 718-20-35-2A through 35-9.

Derivative and Hedging Considerations

Entities should assess the impact that a disaster may have on their derivative portfolios and hedge designations. The paragraphs below discuss some issues that entities should consider.

Probability of Forecasted Transaction Occurring in a Cash Flow Hedge

Upon designation of a cash flow hedge, entities must assert that the occurrence of the forecasted transaction is probable in accordance with ASC 815-20-25-15. Entities should consider whether occurrence of the forecasted transaction is still probable after a disaster. If occurrence of the forecasted transaction is no longer probable, hedge accounting should be discontinued. However, ASC 815-30-40-4 and 40-5 indicate that related gains and losses in accumulated other comprehensive income should only be immediately reclassified to earnings if it is probable that the forecasted transaction will not occur by the end of the originally specified period (as documented at the inception of the hedging relationship) or within an additional two-month period thereafter.

Assessment of Counterparty Default

Entities should consider the risk of counterparty default with respect to their derivative and hedging portfolios. In accordance with ASC 815-20-35-15, if the likelihood that the counterparty will not default ceases to be probable, the hedging relationship ceases to qualify for hedge accounting because the hedging relationship is no longer expected to be highly effective.

Normal Purchases and Normal Sales Exception

ASC 815-10-15-22 through 15-51 provide guidance on the normal purchases and normal sales exception. If it is no longer probable that a contract will not settle net and result in physical delivery, the contract generally no longer qualifies for the scope exception for normal purchases and normal sales. If the contract no longer meets the scope exception, it should be recorded on the balance sheet at its current fair value and marked to fair value on an ongoing basis.

Uneconomic Executory Contracts

Although no consensus was reached on EITF Issue No. 99-14, "Recognition by a Purchaser of Losses on Firmly Committed Executory Contracts," or EITF Issue No. 00-26, "Recognition by a Seller of Losses on Firmly Committed Executory Contracts," these Issues may provide valuable background and highlight matters that entities should consider in connection with firm commitments.

Some firm commitments are derivatives; if so, entities should continue to account for these contracts in accordance with ASC 815. For items accounted for as executory contracts rather than as derivatives, there is no authoritative accounting guidance, other than industry-specific or transaction-specific guidance, that would support the recording of a contingent liability when the fair value of remaining contractual rights of a firmly committed executory contract declines below the remaining costs to be incurred.

Leases for Assets With No Future Economic Benefit

Entities may be committed to lease agreements for property that has been destroyed or has permanently lost its function because of damage resulting from a disaster. ASC 420 requires that if an operating lease is not terminated and the associated asset has no future economic benefit, the entity must recognize a liability as of the cease-use date at fair value, determined on the basis of the remaining lease rentals, reduced by estimated sublease rentals that could be reasonably obtained for the property, regardless of whether the entity intends to enter into a sublease (see ASC 420-10-25-13 and ASC 420-10-30-8). A liability for costs to terminate a contract before the end of its term must be measured at fair value when the entity terminates the contract (see ASC 420-10-25-12 and ASC 420-10-30-7).

Entities should also consider the guidance in the [Overview of Insurance Analysis](#) and [Insurance Recoveries](#) sections of this *Financial Reporting Alert* on insurance proceeds related to losses from, or obligations under, leasing arrangements.

Lease Modifications

A lessor and lessee may decide to modify the terms of a lease agreement as the result of a disaster. In such situations, entities should consider the guidance in ASC 840-10-35-4, which requires lessees and lessors to analyze lease modifications (other than lease renewals or extensions) to determine whether substitution of the modified provisions for the original lease provisions at the inception of the lease would have resulted in a different lease classification at the inception of the lease.

Subleases

For sublet assets, ASC 840-20-25-15 states that "[i]f costs expected to be incurred under an operating sublease (that is, executory costs and either amortization of the leased asset or rental payments on an operating lease, whichever is applicable) exceed anticipated revenue on the operating sublease, a loss shall be recognized by the sublessor." Similarly, ASC 840-30-35-13 states, "The original lessee (as sublessor) shall recognize a loss on a direct financing sublease if the carrying amount of the investment in the sublease exceeds the total of rentals

expected to be received and estimated residual value unless, as sublessor, the original lessee's tax benefits from the transaction are sufficient to justify that result."



Connecting the Dots

The guidance above assumes that the reporting entity has not early adopted ASC 842 and therefore continues to apply ASC 840 to its leasing transactions at the reporting date. Early adopters of ASC 842 should consult with their auditors or other professional advisers to understand potential differences under the new guidance.

Benefit Plan Curtailments or Settlements

As a result of a disaster, businesses may decide not to (or may not be permitted to) reestablish certain operations in an affected area. One impact of that decision (or requirement) may be the termination of employees, resulting in a curtailment or settlement of pension benefits, or both. A settlement is an irrevocable action that relieves the employer (or the plan) of primary responsibility for an obligation and eliminates significant risks related to the obligation and the assets used to effect the settlement. A curtailment is a significant reduction in, or an elimination of, defined benefit accruals for present employees' future services. If either (or both) occurs, certain previously unrecognized amounts (such as gains and losses from experience different from that assumed, the effects of changes in assumptions, and the cost of retroactive plan amendments) must be immediately recognized. A gain or loss that directly results from a curtailment, including a curtailment resulting from an offer of special termination benefits, is first offset against any previously existing unrecognized net loss or gain for that plan, and any excess is then recognized. Depending on the nature of the benefits provided, entities should consider the guidance in ASC 715-30 and ASC 715-60.

Employee Termination Benefits

As a result of business disruptions caused by a disaster, entities may initiate measures to reduce their workforce. In doing so, they may offer various termination benefits that are accounted for under different accounting literature.

One-Time Involuntary Termination Benefits

One-time termination benefits provided to current employees that are involuntarily terminated under the terms of a benefit arrangement that, in substance, is not an ongoing benefit arrangement would be accounted for in accordance with ASC 420. In general, the obligation associated with the one-time termination benefit should be recognized as of the "communication date," as detailed in ASC 420-10-25-8, and measured at fair value in accordance with ASC 420-10-30-5. The communication date is defined as the date on which the plan of termination meets all the criteria in ASC 420-10-25-4 and has been communicated to employees.

Involuntary Termination Benefits

ASC 420 does not apply to termination benefits to be paid to terminated employees that are part of a substantive preexisting ongoing employee benefit plan. Such benefits should be accounted for in accordance with other guidance, such as ASC 715-30, ASC 715-60, ASC 712, or ASC 710.

Voluntary Termination Benefits

Entities offering a voluntary termination benefit to employees in an effort to reduce their workforce should consider the guidance in ASC 712-10-25-1, which indicates that a liability and loss generally should be recognized "when the employees accept the offer and the amount can be reasonably estimated."

Contributions Made or to Be Made

In response to a disaster, some entities may either donate or commit to donate to the relief effort. ASC 720-25 outlines the guidance on recognition and measurement of contribution expenses and obligations. In general, contributions are recognized as expenses in the period in which the contribution is made at the fair value of the assets donated or liabilities canceled.

Promises to Contribute

Unconditional promises to give are recognized at fair value in the period in which the promise is made. Conditional promises to give are recognized when they become unconditional (i.e., when the conditions are substantially met). A conditional promise to give is considered unconditional if the possibility that the condition will not be met is remote.

Income Tax Impact

Contributions to certain organizations are not deductible for income tax purposes, resulting in a permanent tax difference that increases an entity's effective tax rate. In certain limited circumstances, donations of nonmonetary assets may be recorded at carrying value for book purposes but at fair value for tax purposes, thereby creating a permanent tax difference. These permanent differences should be reflected in the entity's quarterly and annual income tax provisions. However, ASC 740-270-30-6 requires that, at the end of each interim period, an entity "make its best estimate of the effective tax rate expected to be applicable for the full fiscal year." Therefore, the entire tax impact will not necessarily be reflected in the quarter in which the contribution occurs (particularly when a disproportionate amount of contributions is made in a single interim period).

Assistance Received From Outside Entities (e.g., Red Cross)

After a disaster, some entities may receive contributions from outside entities. Entities that receive monetary or nonmonetary assistance from third parties other than governmental entities should consider ASC 958-605-25. This guidance outlines the timing of recognition and classification of contributions received (cash or services). Contributions received are generally "recognized as revenues or gains in the period received and as assets, decreases of liabilities, or expenses, depending on the form of the benefits received." Because there is no explicit guidance under U.S. GAAP that addresses the accounting for government grants, we believe that it would generally be acceptable for entities that receive assistance or grants from governmental entities (e.g., FEMA in the United States) to account for governmental grants in a manner consistent with IAS 20, *Accounting for Government Grants and Disclosure of Government Assistance*.

Income Taxes

Valuation Allowance

A significant event, such as a disaster, may cause a company to reassess its need for a valuation allowance against deferred tax assets (DTAs). A DTA is reduced by a valuation allowance if, on the basis of the weight of positive and negative evidence available, it is more likely than not that some portion or all of a DTA will not be realized (under ASC 740). Whenever negative evidence is present, the determination of the amount of the valuation allowance needed to reduce the DTA to an amount that is more likely than not to be realized depends on the existence of positive evidence supporting the future utilization of the DTA. One form of positive evidence may be the existence of deferred tax liabilities (DTLs), which would result in future taxable income upon reversal; however, a significant event resulting in financial losses may also result in the loss of such DTLs because of asset impairments or write-offs. Another significant form of positive evidence is an estimate of future taxable income. Generally, discontinued operations, cumulative effects of accounting changes, extraordinary items, and even certain nonrecurring items are not indicative of an entity's ability to generate taxable

income and may be excluded from projections. However, unusual loss allowances, poor operating results caused by an economic downturn, operating losses attributable to a change in the focus or directives of a subsidiary or business unit, and, by extension, poor near-term and projected operating results caused by a disaster, whether related to operations in the affected area or outside it, are generally not considered nonrecurring in the forecasting of taxable income and therefore generally are considered in such projections. Thus, a significant disaster could potentially lead a company to conclude that it may not generate sufficient results in the future to realize its existing DTAs and to therefore determine that a valuation allowance and related disclosures are required.

Management's previous estimates of state or global apportionment should also be revisited as income shifts from operations that are more directly affected to those that are less affected. This consideration is important to the evaluation of an entity's ability to use certain state or foreign tax attributes.

Transfer Pricing

Companies should also reassess the continuing propriety of transfer pricing arrangements between a parent and a subsidiary. The average profitability of benchmark companies underlying the most recent transfer pricing analyses may change, triggering a disconnect between expectations set by regional tax authorities and the modified margins achieved through transfer pricing.

Indefinite Reinvestment of Foreign Earnings

Any potential shift in earnings between foreign entities or jurisdictions may also affect regional cash needs, and companies that have successfully avoided U.S. taxation on indefinitely reinvested foreign earnings in the past will need to reconsider whether they will successfully qualify for such treatment on an ongoing basis. Foreign earnings that were previously treated as indefinitely reinvested may need to be repatriated to the United States in the future to meet debt service requirements or other cash needs of the U.S. parent company, in which case a company would be required to establish a DTL related to the future taxation of such income in the United States.

Interim Accounting for Income Taxes

All of the items noted above may affect a company's interim accounting for income taxes. The estimated annual effective tax rate applied to year-to-date earnings in interim periods should take into account all changes to forecasted earnings and book-tax differences affected by the event, including changes in the company's ability to use certain state or foreign tax attributes, its need for a valuation allowance, transfer pricing changes, and its ability to avoid U.S. taxation on undistributed earnings of subsidiaries. Certain significant events may result in losses or permanent book-tax differences during the period that are considered significant, unusual, or extraordinary under ASC 740 and therefore may warrant treatment as discrete items to be excluded from the calculation of the estimated annual effective tax rate. In addition, a disaster may result in a significant loss carryforward in a certain jurisdiction that will require a full valuation allowance or may result in an operation for which management cannot develop reliable estimates. The tax effects of significant unusual or infrequently occurring items should be treated as discrete and excluded from the calculation of the annual effective tax rate.

If the significant event occurred after the end of an interim period but before financial statements are completed, an entity may want to consider the potential impact on the annual effective tax rate. In certain circumstances, it may be acceptable for an entity to adopt a policy to reflect the impact of such an event in its calculations or to disclose the potential impact in the footnotes to its financial statements.

Debt Classification

A disaster may cause an entity to violate a debt covenant or otherwise give the lender the ability to call the debt. The lender may waive its right to call the debt. Such circumstances can call into question the classification of long-term debt (i.e., whether the long-term (noncurrent) debt or some portion of it should be reclassified to current). ASC 470-10-45-1 provides guidance on this issue. Under this guidance, the debt, or portion thereof, would only be reclassified as current if both the following conditions are met:

- a. A covenant violation that gives the lender the right to call the debt has occurred at the balance sheet date or would have occurred absent a loan modification.
- b. It is probable that the borrower will not be able to cure the default (comply with the covenant) at measurement dates that are within the next 12 months.

Enhanced Disclosures

Entities may need to add disclosures both in the footnotes to the financial statements as well as in MD&A about the impact of a disaster that has recently occurred. Such disclosures may need to be added to Form 10-Q and Form 10-K filings, to registration statements, or to relevant documents for nonpublic companies. For example, entities may need to discuss amounts of losses incurred and the amounts of insurance claims recorded and expected ultimate insurance recoveries. MD&A disclosures should address the reasonably likely effects of known trends and uncertainties, which could include discussions of the uncertainties associated with potential insurance recoveries, the impact of the disaster on the entity's liquidity, and forward-looking assessments of the future impact of the disaster on operations, liquidity, and financial position.

Entities should consider providing additional disclosures, such as the following, in the notes to the financial statements in all periods affected by the disaster:

- A description of the nature and amounts of losses and costs recognized as a result of the event and the amount of related insurance recoveries (if any) recognized.
- A description of contingencies resulting from the event that have not yet been recognized in the financial statements but that are reasonably expected to affect the entity's financial statements in the near term (e.g., future losses or future insurance recoveries).
- Applicable disclosures under ASC 275.
- Applicable disclosures about environmental obligations (and recoveries) under ASC 410-30.

Entities should also ensure that they have met the disclosure requirements in SEC Staff Accounting Bulletin Topic 5.Y, "Accounting and Disclosures Relating to Loss Contingencies." Those requirements address financial statement disclosures related to discounted liabilities, recorded and unrecorded product or environmental remediation liabilities, and site restoration or other environmental remediation costs. They also address potential disclosures outside of the financial statements (e.g., in MD&A, legal proceedings, or description of the business). The availability of insurance, indemnification, or contribution may be relevant to the determination of whether the disclosure criteria have been met for a contingency.



Connecting the Dots

Entities should also consider whether they would need to provide additional disclosures, such as a summary of their operations in the region affected by the disaster, to help investors understand the overall effect on the consolidated entity. At the February 2016 “SEC Speaks” conference, Craig Olinger, deputy chief accountant in the SEC’s Division of Corporation Finance, discussed MD&A disclosure related to the potential implications of market turmoil. His remarks may also be useful to an entity in its consideration of how best to address the disclosure implications of the impact of the recent natural disasters. While Mr. Olinger highlighted the types of MD&A disclosures a registrant should consider providing to investors to describe the effects of adverse market events (e.g., commodities fluctuations or interest rate uncertainty) on an entity’s operations, an entity may consider providing the following similar disclosures about its operations in a region affected by the disaster:

- Information about the business and the financial risks of the operations in the region (e.g., recent or expected changes in business practices to address prevailing conditions in the environment).
- Known trends, demands, commitments, events, or uncertainties that will have, or are reasonably likely to have, a material effect on the company’s future liquidity, capital resources, and results of operations.

In addition, SEC Regulation S-K, Item 503(c), “Risk Factors,” and SEC Regulation S-K, Item 305, “Quantitative and Qualitative Disclosures About Market Risk,” require registrants to disclose risks, including risk factors and market risk. The SEC staff has emphasized that registrants should present tailored risk factors in their filings and avoid using boilerplate language. Registrants should consider whether to provide more specific discussion and enhanced explanations of how the risk related to the recent natural disasters could materially affect their business. This discussion may be supplemented with quantitative information that provides additional context about the risks.

Below are two examples of MD&A disclosures made immediately after a disaster.

Examples of MD&A Disclosures

- On October 28 and 29, 2012, most of the eastern coast of the United States of America, including the New York City metropolitan area, was subjected to Hurricane Sandy. The Bank is currently assessing the impact of Hurricane Sandy, which caused extensive damage throughout its market area, and may have adversely affected the collateral of some of its borrowers and, to a lesser extent due to property and flood insurance, their ability to repay their obligation to the Bank. In addition, storm related power outages temporarily interrupted the Bank’s ability to operate some of its branches. Although, at the time of this filing, Bank operations have resumed without disruption and loan repayments are recurring systematically, the possibility exists that these events could adversely affect future earnings or delinquencies.
- In late October 2012, Hurricane Sandy struck New Jersey, New York, Connecticut and several other east coast states causing substantial damage and power outages to the areas. While within a week our customers re-opened their casinos, we currently expect the aftermath of Hurricane Sandy to reduce casino visitation in Atlantic City and other affected casinos, which may negatively impact demand for new gaming machines and the revenue per day for our gaming operations for future months.

Subsequent Events

After a disaster, many affected areas may remain inaccessible and damage estimates may evolve over time. Entities and their independent auditors will therefore need to carefully evaluate information that becomes available after the balance-sheet date but before the issuance of the financial statements. ASC 855-10-25-1 and ASC 855-10-25-3 provide guidance on evaluating subsequent events and indicate:

An entity shall recognize in the financial statements the effects of all subsequent events that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements. See paragraph 855-10-55-1 for examples of recognized subsequent events.

An entity shall not recognize subsequent events that 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 or are available to be issued. See paragraph 855-10-55-2 for examples of nonrecognized subsequent events.

The guidance in ASC 855-10-55-2 includes losses of plant or inventories as a result of fire or natural disaster that occurred after the balance sheet date but before financial statements are issued or are available to be issued as an example of a nonrecognized subsequent event. In addition, ASC 855-10-55-1A requires that SEC filers and conduit bond obligors for conduit debt securities that are traded in a public market evaluate subsequent events through the date the financial statements are issued.

Going-Concern Assumptions

Preparer Responsibilities

In some cases, an entity may incur such substantial losses or experience such significant liquidity concerns that the entity's ability to continue as a going concern is called into question. In connection with the preparation of financial statements for each annual and interim reporting period, ASC 205-40 requires an entity's management to evaluate whether there are conditions and events, considered in the aggregate, that raise substantial doubt about an entity's ability to continue as a going concern within one year after the date that the interim or annual financial statements are issued (or available to be issued when applicable). The evaluation (1) is based on relevant conditions and events that are known and reasonably knowable at the date that the financial statements are issued and (2) initially cannot take into consideration the potential mitigating effect of management's plans that have not been fully implemented as of the date that the financial statements are issued. ASC 205-40 requires an entity to make disclosures in the annual and interim financial statements when events and conditions are identified that raise substantial doubt about an entity's ability to continue as a going concern within one year after the financial statements are issued. Such disclosures are required even when management's plans alleviate such doubt about the entity's ability to continue as a going concern. If these plans do not alleviate substantial doubt about the entity's ability to continue as a going concern, in addition to the required disclosures, management must make a statement in the notes to the financial statements indicating that there is substantial doubt about the entity's ability to continue as a going concern within one year after the date that the annual or interim financial statements are issued.

Auditor Responsibilities

Independent auditors also have a responsibility to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern in connection with their audits of the annual financial statements. PCAOB Auditing Standard No. 2415, *Consideration of an Entity's Ability to Continue as a Going Concern*, and AICPA Professional Standards AU-C Section 570, "The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern," provide independent auditors with guidance on making this evaluation. In addition, in connection with an independent auditor's review of interim financial information performed in accordance

with PCAOB Auditing Standard No. 4105, *Reviews of Interim Financial Information*, or AICPA *Professional Standards* AU-C Section 930, "Interim Financial Information," the independent auditor should perform interim review procedures (e.g., inquiries) related to (1) whether the going concern basis of accounting is appropriate, (2) management's evaluation of whether there are conditions or events that raised substantial doubt about the entity's ability to continue as a going concern, (3) management's plans to mitigate conditions or events that raised substantial doubt about the entity's ability to continue as a going concern, and (4) the adequacy of the related disclosures in the interim financial information. Further, if a public company is filing a registration statement that requires the auditor to reissue its opinion on the most recent annual financial statements, the auditor may need to consider the ramifications of a disaster on the entity's ability to continue as a going concern.

Internal Control Implications

The effects of a significant, unforeseen event, such as a disaster, may even extend to an entity's internal control over financial reporting (ICFR). For example, an entity may need to design and implement new controls or modify existing controls. Such controls may relate to the selection and application of GAAP for issues arising as a result of the disaster.

Any changes that have materially affected, or are reasonably likely to materially affect, the entity's ICFR must be disclosed in Item 4 or Item 9A, "Controls and Procedures," of the entity's quarterly or annual filings, respectively (or Item 15 of Form 20-F for foreign private issuers).

Audit Committee Communications

Entities that have been affected by a disaster should communicate with their audit committees regarding the financial statement impacts. Those discussions should include the significant judgments and estimates made (e.g., the amount and probability of insurance recovery, asset impairments) as well as the accounting principles applied.

In addition, affected entities should expect that their independent auditors will also be having discussions with the audit committee. PCAOB Auditing Standard No. 1301, *Communications With Audit Committees*, and AICPA *Professional Standards* AU-C Section 260, "The Auditor's Communication With Those Charged With Governance," require an entity's independent auditor to provide the audit committee with additional information regarding the scope and results of the audit that may help the audit committee oversee the financial reporting and disclosure process for which management is responsible. Given the significant effects that the disaster may have on entities' operations and financial statements, those discussions may include how certain items were accounted for and disclosed. For example, paragraph 12(c) of PCAOB Auditing Standard 1301 requires the auditor to communicate the process management used to develop critical accounting estimates, the significant assumptions management used to develop the critical accounting estimates that have a high degree of subjectivity, and any significant changes made by management to the processes used to develop critical accounting estimates and significant assumptions, including the reason for the changes and the effects on the financial statements. As discussed above, there may be a significant level of judgment and estimation required regarding the solvency of insurance providers, the amount of expected insurance recoveries, and the impairment of assets.

AICPA Technical Practice Aid for Natural Disasters

As noted above, AICPA Technical Practice Aids, TIS Section 5400.05, "Accounting and Disclosures Guidance for Losses From Natural Disasters — Nongovernmental Entities," was issued in September 2005 to assist entities with the accounting issues that arise in conjunction with natural disasters.

SEC Relief

After some disasters, the SEC may provide broad-based filing or other relief from various regulatory requirements. On September 28, 2017, the SEC staff **announced** measures to help publicly traded companies, investment companies, accountants, transfer agents, municipal advisers, and others affected by Hurricanes Harvey, Irma, and Maria comply with filing deadlines and other federal securities laws and regulations. Such measures include the following Exchange Act annual or quarterly report filing deadline extensions for affected registrants:

- To October 10, 2017, for any filing due from August 25, 2017, to October 6, 2017, for those affected by Hurricane Harvey.
- To October 19, 2017, for any filing due from September 6, 2017, to October 18, 2017, for those affected by Hurricane Irma.
- To November 2, 2017, for any filing due from September 20, 2017, to November 1, 2017, for those affected by Hurricane Maria.

Additional exemptions were provided for proxy and information statement delivery requirements, investment companies, transfer agent compliance rules, and auditor independence rules. The auditor independence exception was limited to reconstruction of previously existing accounting records that were lost or destroyed as a result of any of the identified hurricanes, and such services were required to cease as soon as the client's lost or destroyed records were reconstructed, its financial systems were fully operational, and it was able to effect an orderly and efficient transition to management or another service provider. These services are still subject to preapproval by the issuer's audit committee.

The SEC has also indicated that other requests for additional relief would be considered on a case-by-case basis. Entities are encouraged to consult with their auditors or SEC counsel and, if necessary, the SEC staff if they believe that specific facts and circumstances warrant other relief or additional guidance.

Tax Authority Relief

Some disasters may result in the tax authorities' providing filing or other tax relief. The IRS is providing certain relief to victims of **Hurricane Harvey** and **Hurricane Irma**. Entities should continue to monitor the IRS or other taxing authorities for further announcements related to the hurricanes.

Questions

Deloitte clients with questions about this *Financial Reporting Alert* should contact their engagement partner or managing director. Deloitte engagement teams should direct questions to an appropriate subject-matter resource in Deloitte's Professional Practice Network.

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