ARTICLE

Reporting issuers and COVID-19: Financial reporting and audit impacts

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Global reactions and responses to coronavirus (COVID-19) continue to evolve and change. The implications of this virus are far reaching. It's impacting the daily operations and economics of many public companies. With the concerns over spreading illness, entities have implemented protective measures including:

- restrictions on the movement of people,
- cancellation of conferences and large meetings,
- work-from-home arrangements for personnel,
- closures of facilities, head offices, operating branches, and
- limits on non-essential travel.

This pandemic has led to widespread economic uncertainty and volatility in financial markets. This uncertainty is especially pronounced for reporting issuers whose share price may be fluctuating tumultuously in the stock markets. The measures taken across the globe to try to slow the spread of COVID-19 are impacting both the supply and demand for many goods and services. Although fiscal and monetary policy measures are also being implemented to prop up the economy, many still believe there is likelihood of a global recession.

This uncertainty of COVID-19 impacts reporting issuers and their financial reporting.

Accounting standards require the consideration of conditions that existed as at the reporting date. As the World Health Organization (WHO) did not declare the COVID-19 outbreak to be a public health emergency until January 2020, any significant changes in business and economic events due to COVID-19 would be considered a non-adjusting subsequent event for entities whose year-end is on December 31, 2019 or earlier. The impact of the virus on financial statement disclosures should be considered for reporting issuers. For further information, see our International Financial Reporting Bulletin: Potential effects of the coronavirus outbreak on 31 December 2019 year-end financial reporting.

In periods ended subsequent to the outbreak of COVID-19, the potential accounting implications are even broader. Reporting issuers should consider the impact on both the recognition and measurement of amounts, and the disclosures surrounding them. See BDO's International Financial Reporting Bulletin: Potential effects of the coronavirus outbreak on 2020 reporting periods and onward on this topic.

In any of these situations, a key step is to discuss a plan tailored to the needs of your particular business. The list of considerations below is not complete; and will likely evolve as the situation changes. Therefore, early and regular discussions are recommended.

Accounting considerations

At a high level, there are a number of financial reporting matters that COVID-19 impacts. These include asset impairment, revenue recognition, penalties, debt restructurings, and reimbursements. It's also important to ensure that reporting issuers provide sufficient disclosures in the notes to the financial statements and their regulatory filings with information about the entity that's useful to existing and potential investors, lenders, and other decision-making creditors.

Impairment

The effects of the COVID-19 outbreak should not be considered in impairment of financial and non-financial assets when reporting on periods ending on or before December 31, 2019. Consequently, forecasts, projections, and valuations for impairment calculations as at December 31, 2019 will need to be carefully reviewed to ensure that significant events related to the COVID-19 outbreak are not being incorporated in hindsight. However, if these estimates are expected to change significantly due to the factors brought on by COVID-19 subsequent to year end, additional disclosures should be considered.

In periods ended subsequent to the outbreak of COVID-19, including interim financial reporting, the impact on expected credit losses and future cash flow projections used in impairment testing will need to be considered.

Many companies in a multitude of sectors will experience an economic loss because of this virus. These incurred and expected losses need to be examined for significance and duration to determine the impact on impairment assessments. Inventory, goodwill, intangible assets, non-financial assets, financial assets, and investments will all need to be assessed.

Consider the example of a reporting entity in the mining industry that has elected to capitalize exploration and evaluation assets. Indicators of impairment may exist at the interim reporting date. Given the significant decrease in global commodity prices, significant impairment of exploration and evaluation assets is expected.

Public companies that issue quarterly financial statements will need to consider information available at the reporting date related to impairment and other significant estimates. This means that quarterly financial statements issued after the outbreak of COVID-19 may have significantly different measurement of financial statement line items and disclosures than the annual ones issued prior to the outbreak. Issuers will need to assess whether impairment indicators exist at quarterly and annual reporting periods. This may mean that a company is doing multiple impairment tests throughout the year. Entities should be prepared for the extra time that will be involved in making such estimates.

This may result in material variances when compared to the prior quarter and prior year-to-date figures. Consider the example of an airline and hotel operator that issues its first-quarter financial statements as at March 31, 2020. The Q1-2020 reported amounts will be very different than those of its annual financial statements at December 31, 2019 and its Q1-2019 interim financial statements. As a result, to explain the impact of the outbreak to the stakeholders, reporting issuers will need more robust disclosures in these quarterly financial statements than they have in prior interim periods.

In the measurement of impairment, an entity may rely on fair value measurements at interim and annual periods. The objective of a fair value measurement is to determine the price at which an orderly transaction would take place between market participants under the market conditions that existed at the measurement date. Given that the impact of the virus continues to evolve, careful consideration will need to be applied to determine if appropriate valuations are being applied consistently. Our valuation team can help companies with such issues.

Revenue recognition

The amount of revenue recognized and the pattern of revenue recognition will be impacted by COVID-19. Entities may need to account for returns and refund liabilities.

Consider the example of large conglomerates with flexible return policies and consumers stocking up non-perishable items. These unused goods may be returned once the virus has stabilized. Large-scale event organizers and multi-location athletic facilities may provide refunds for cancelled events and memberships.

For entities that recognize revenue over a long period of time, the pattern of revenue recognition may change for delays in rendering services.

Penalties related to termination of contracts

Conversely, an entity may incur significant penalties for terminating contracts. For example, conferences and events are being cancelled, which can result in loss of deposits and/or require penalties to be paid. These non-recurring costs will need to be appropriately recognized, measured, presented, and disclosed in financial statements. Even when an entity has not made a decision to cancel an event, consideration will have to be given to the issues related to deposits and potential penalties if the event cancellation is probable in the future. It's important that you review your contracts for termination and force majeure clauses. While IAS 37 does not permit the recognition of future operating losses as liabilities, losses arising from onerous contracts may increase as the unavoidable costs could exceed the economic benefits derived from the contract. For example, if an entity is obligated to pay costs for a conference held after the end of the reporting period, but it has cancelled the conference due to the COVID-19 outbreak, the cost of the conference would be recognized as a liability at the time of cancellation as it would be an onerous contract (i.e. unavoidable costs exceed the economic benefits).

Leases

Similarly, lessees will need to consider the impact of the disruption on the impairment of the right of use assets, the determination of lease term, and lease modifications. Consider an example of a lessee who leases retail space in an airport. Landlords may offer concessions to tenants (ex. Rent-free periods, deferral of payment, cash payments from lessors to lessees, etc.) to compensate them for disruptions to operations. Determining how to account for such concessions will depend on the precise terms of the lease contract and the nature of the concessions.

Debt restructurings

In an uncertain economic environment, an entity may have a decline in cash inflows and as such may seek additional financing, revise repayment terms and interest rates of existing debt agreements, or request waivers if they no longer satisfy debt covenants. Such revisions may have an impact on the classification and measurement of financial liabilities presented on the balance sheet. Our Financial Recovery Services team can walk entities through the process of renegotiating debt agreements.

Reimbursements

Entities that have business disruption insurance may be entitled to a certain amount of insurance proceeds to cover some or all costs. In addition, there may be government grants/incentives available to help support businesses. In many cases, determining if an entity is actually covered or eligible will require a detailed analysis of the policy or grant criteria. Given that we're in unprecedented times, careful technical interpretation of the policy/grant criteria and the accounting standards is required to determine the appropriate presentation and disclosures. Our Financial Advisory Services team can help address this with a focus on business interruption insurance work and government incentives.

Deferred taxes

Entities that have deferred tax assets need to consider whether they meet the requirements for recoverability. If they do not, they will not meet the recognition criteria in IAS 12. Similar to an assessment of going concern, an assessment of the likelihood of an entity being able to recover the value of deductible temporary differences needs to consider all available information. Given the disruption to operations caused by COVID-19, forecasts may need to incorporate extremely severe 'down side' forecasts. Tax losses and other deductible temporary differences having no fixed expiry or a very long-term expiry (ex. 20 years) is not a justification for the recognition of associated deferred tax assets.

Financial statement disclosures

Transparent disclosures should be made on the effects and risks of this outbreak on the company. This disclosure would generally provide information on the nature of the event and a qualitative or quantitative estimate of its effect on the financial statements.

> "As the virus evolves, so will the financial impact and disclosures."
>
> — **Armand Capisciolto**, *National Accounting Standards Partner, FCPA; FCA*

Public disclosure documents for reporting issuers

Public companies will have to consider this from both a financial statement standpoint and for their other public disclosure documents, including the Management Discussion & Analysis (MD&A) and Annual Information Form (AIF). Reporting issuers must consider whether disclosure is required to address the potential impact of the outbreak on business operations and financial results. Entities should consider the inclusion of risk factors and forward looking information in its MD&A and AIF.

Such risk factors include disruptions to business operations resulting from:

- quarantined employees;
- customers and suppliers in areas affected by outbreak;
- closures of manufacturing facilities and supply chains;
- travel restrictions;
- reduced consumer spending;
- effects on proposed acquisitions or planned expansions; and
- overall uncertainty surrounding the impact of the spread of the virus.

Along with risk factors, entities should consider the impact of COVID-19 on forward-looking information and whether it remains reasonable to disclose. Entities should consider relationships within the reporting issuers' customer base and supply chain. Companies may face the challenge of being able to reasonably predict the actions of others in uncertain, ever-changing times on a global front. Where forward-looking information continues to be disclosed, entities should:

- identify material risk factors that could cause actual results to differ;
- disclose material factors and assumptions used to develop the information; and
- disclose in subsequent MD&A any material differences between actual results and any FOFI or financial outlook previously disclosed.

Reporting issuers should avoid boilerplate disclosure concerning COVID-19 in upcoming filings. Rather, they should focus on entity-specific information that is clear and relevant to allow investors to fully understand how the business is impacted by the outbreak. As the virus evolves, so will the financial impact and disclosures. Entities should ensure that processes are in place to continue to monitor and update the impact of this outbreak on the financial statements and the related disclosures.

Going concern

In assessing the entity's ability to continue as a going concern, management must take into account events after the date of the financial statements. Regardless of the reporting period, management will have to consider all factors known up to the date of authorization of the financial statements. For those companies affected by the outbreak, management will need to look at the following in assessing going concern:

- updated financial forecasts for the foreseeable future, but not less than a 12-month period;
- updated sensitivity analysis;
- forecasted compliance, or lack thereof, with banking and other covenants for the foreseeable future; and
- any other information available up to the date the financial statements are authorized for issuance.

Based on the information available, an entity will consider whether or not there is material uncertainty which raises significant doubt about their ability to continue as a going concern. In extreme cases, an entity will need to determine if the financial statements should be prepared on a going concern basis, or if another basis of preparation would be more appropriate.

We can help you manage the financial reporting implications for your company resulting from COVID-19.

Reporting deadline

The Canadian Securities Administrators (CSA) announced on March 18, 2020 it will provide temporary relief from some regulatory filings required to be made on or before June 1, 2020. The blanket relief will provide a 45-day extension for periodic filings normally required to be made by issuers, investment funds, registrants, certain regulated entities and designated rating organizations on or before June 1, 2020. This will include financial statements, management's discussion and analysis, management reports of fund performance, annual information forms, technical reports, and certain other filings. Issuers choosing to rely on this exemption and that are complying with the conditions of the relief will not need to file applications for management cease trade orders as they will not be noted in default. Also, CSA proposals currently out for comment will have their comment periods extended by 45 days.

This is similar to the relief provided by the Securities and Exchange Commission (SEC) in the United States.

On March 4, 2020, the SEC announced that it is providing conditional regulatory relief for certain publicly-traded company filing obligations under the federal securities laws. These companies may include U.S. companies located in the affected areas, as well as companies with operations in those regions. To address potential compliance issues, publicly traded companies will have an additional 45 days to file certain disclosure reports that would otherwise have been due between March 1 and April 30, 2020. The SEC also indicated it may extend the time for the relief or provide additional relief as circumstances warrant.

The extension provided by both the CSA and the SEC will provide relief to both companies and auditors alike in the issuance of financial statements and audit reports for reporting issuers.

Audit implications

As the outbreak progresses, some of the business decisions made by entities, like restrictions on the movement of people, work from home arrangements for personnel, and closures of head offices and operating branches, may restrict the auditors' access to financial records potentially affecting reporting deadlines. Questions to consider:

- Will the auditor have access to attend inventory counts?
- How can the required audit information be provided to the auditor if either the auditor or the entity imposes mandatory or voluntary quarantines (i.e. no access to the office to obtain the information)?
- How will the timing of the audit be affected from workforce shortages due to illness or travel restrictions?
- How will the adjustments to internal controls affect the ability of the auditor to complete their audit? (i.e. to address the supporting information required to issue an audit opinion? Consider:
  - Inability to obtain bank confirmations due to bank closures
  - Inability to share information across borders due to local regulations

Some of these questions may not have a good answer, and for those that do, the answer may be constantly evolving along with the situation. Some alternatives to consider are:

- How can technology help to address these concerns?
  - Technologies such as screen-sharing, teleconferencing and video conferencing can help to disseminate information without requiring either party to be physically present.
  - Where groups of companies share the same information technology systems, there is the possibility that auditors in unaffected regions could access the information for a subsidiary in a heavily affected region through an access point locally.
- What information will the auditors have limited access to, and is this important to the users of the financial statements, such as the bank or lender?
  - Even with available technology, the auditor may not be able to get all the information they need. An example of a situation where there are limited alternatives is the attendance of the auditor at the year-end inventory count. If the auditor, or a representative acting on their behalf, is unable to attend the count, there is little else they can do to verify the inventory balance. This may result in a qualified audit opinion or a delay to the reporting deadline. In many cases, delivering an unqualified audit report by a certain date is required by debt covenants, therefore qualifications and delays create additional financial reporting implications.

TO LEARN MORE, CONTACT YOUR LOCAL BDO PARTNER OR:

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