ARTICLE

COVID-19: Financial reporting and audit implications

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Several months into the coronavirus pandemic, widespread economic uncertainty and volatility still exists. The measures taken across the globe to try to slow the spread of COVID-19 affected 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, the pace and stability of economic recovery and the long-term impact of the crisis still remain difficult to predict, especially as we enter a second wave.

This uncertainty may have implications on financial reporting for your organization. As the calendar year comes to a close, it's crucial to know how the crisis affects your financial reporting responsibilities, if you haven't done so already. A BDO advisor can help you understand what the full impact will be and determine next steps to manage the situation.

Your BDO advisor can assist in developing 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.

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Accounting considerations

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

Impairment

Due to the outbreak of COVID-19, the impact on expected credit losses and future cash flow projections used in impairment testing will need to be considered.

The hospitality industry incurred sharp declines in revenue from a sudden drop in travel and consumer spending, but the impact is not limited to the leisure industry. All industries have been impacted, even essential businesses and businesses that have since reopened. For example, the cost to comply with public health guidelines, supply chain issues, and general uncertainty affects every entity.

Many companies in a vast array of sectors have experienced 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.

In the measurement of impairment, an entity may rely on fair value measurements. 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 may 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 have been returned once the initial panic over the virus stabilized. Event organizers and private education centres may provide tuition refunds for cancelled classes and events.

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 have incurred significant penalties for terminating contracts. As an example, many conferences and events were cancelled, which resulted in loss of deposits and/or required 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.

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 have been and will likely be more 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.

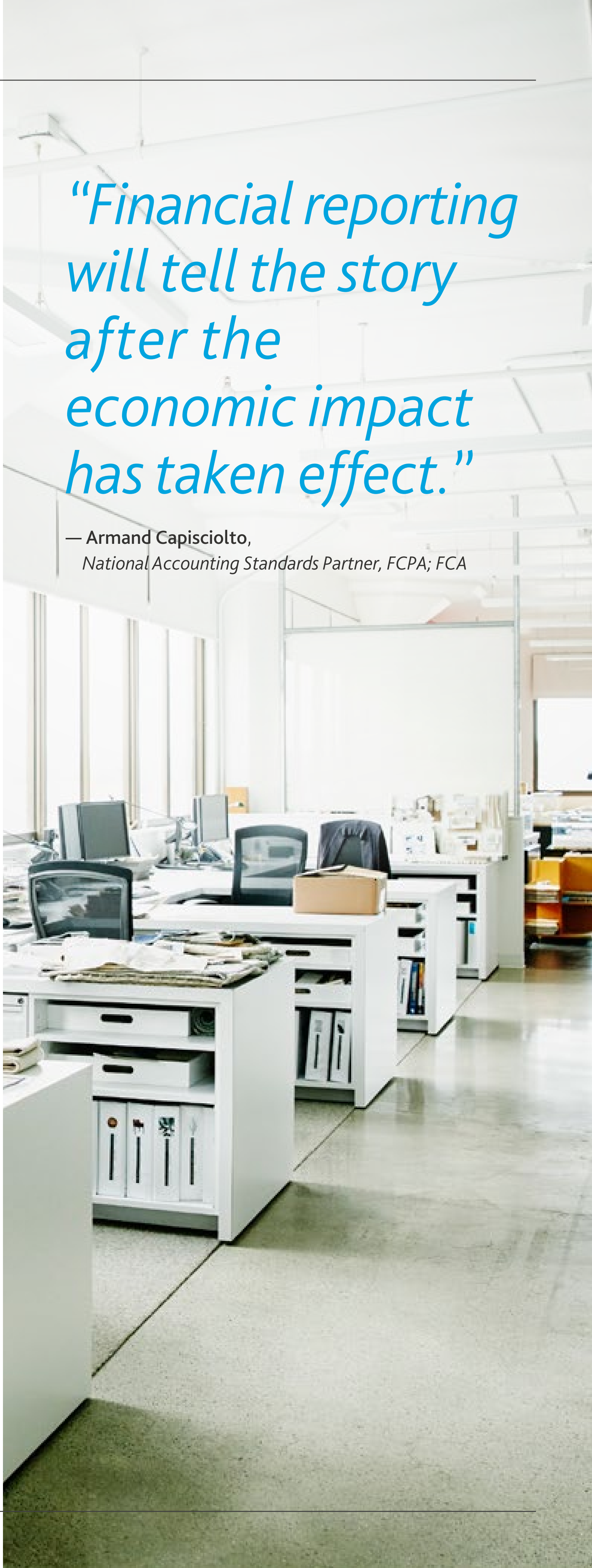
Disclosures

Transparent disclosures should be made on the effects and risks of the 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. Entities—especially listed ones—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).

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. 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.



"Financial reporting will tell the story after the economic impact has taken effect."

— **Armand Capisciolto**,
National Accounting Standards Partner, FCPA; FCA

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.

Audit implications

Some of the business decisions made by entities during the crisis, 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. These questions are arising again as we enter the second wave of the virus:

- 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 impact of COVID-19, or from changes in personnel due to quarantining)
- Do the entity or its subsidiaries do business overseas? If audits are required in these locations, how can the auditor gain access to 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.

Other BDO resources available:

For further information, see our International Financial Reporting Bulletins:

- Potential Effects of the Coronavirus Outbreak on December 31, 2019 Year-End Reporting
- Potential Effects of the Coronavirus Outbreak on 2020 Reporting Periods and Onwards

TO LEARN MORE, CONTACT YOUR LOCAL BDO PARTNER OR:

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