COVID-19: Implications on Your Company's Accounting & Reporting

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Many Canadian businesses are dealing with the immediate impacts of COVID-19 on revenue, earnings and cashflow as a direct result of temporary closures and supply chain disruptions. These events will have varying accounting and financial reporting implications that will depend on the unique circumstances of your business and the industry in which you serve. It is important to understand the potential impact on your business' financial statements before year end, to avoid surprises and manage your stakeholder expectations.

Accounting Impact

Customer Credit Risk

Your customers may be experiencing similar business challenges which increases your risk of financial loss resulting from their inability to pay.

- Communicate with your customers more frequently to gauge their ability to weather the storm and to anticipate any future collection issues
- Assess the status of open accounts and determine whether collection delays are temporary or if there is a risk those receivables may go uncollected
- Discuss and agree upon payment plan options

Certain bank facility agreements have stipulations with respect to borrowing limits based on aging limits of your receivables. For example, only receivables outstanding for 90 days or less, and are in good standing, may be considered credit worthy. Have conversations with your lender and discuss whether modifications can be made, at least on a short-term basis, with respect to borrowing terms.

Allowance for Doubtful Accounts and Your Banking Agreement

In some cases, a review of your allowance for doubtful accounts is needed to assess whether an increase is required. A significant increase in doubtful accounts will, in turn, decrease your company's working capital. This may have a negative impact associated financial covenants.

IT IS IMPORTANT TO UNDERSTAND THE POTENTIAL IMPACT ON YOUR BUSINESS' FINANCIAL STATEMENTS BEFORE YEAR END.

Managing Your Inventory Levels – It's a Balancing Act

The performance of many businesses is dependent on their inventory. Too much inventory can be a sign that there is a significant amount of tied up cash. As a result, a business may struggle to meet cash flow requirements needed to meet obligations and to make capital investments. On the other hand, when insufficient inventory is maintained, shortages may arise that may result in lost sales and an inability to meet customer demands, damaging brand reputation.

Depending on the industry, businesses that hold a significant amount of inventory may face varying challenges during these turbulent times. For example, those supplying essential services, such as grocery stores and food supply chains, are experiencing challenges in keeping shelves stocked. Companies serving the fashion apparel industry, however, may be experiencing challenges in selling their products as customers scale back on discretionary spend in times of uncertainty.

What are the risks and how can you manage them?

Obsolete Inventory

- Monitor inventory levels closely and assess whether there are any inventory items that are not turning over as quickly as they had prior to the pandemic outbreak.
- Review and assess your company's inventory provisions and consider whether additional provisions are required. This will be especially important for businesses that hold any kind of perishable inventory or seasonal inventory which may be difficult to sell at a later time.

Valuation of Inventory and its Net Realizable Value

- Revisit your cost formulas and be proactive in adjusting for the changes in current economic conditions, such as adjusting for the impact of foreign exchange on cost of goods purchased.
- For companies applying standard cost methods, consider revisiting normal plant capacity versus actual utilization, as well as, material and labour efficiencies or inefficiencies. Assessing your overhead allocations and labour costs in the event that your business no longer operates under normal capacity may have a considerable impact on how overhead costs are allocated to inventory on hand and, ultimately, on your company's gross margin. Allocation methods will need to be revisited to assess whether inventory values are appropriately recognized at year end.
- For companies applying the retail method to cost inventory, consider revisiting gross margins used to determine cost. Changes in the current environment will impact inventory costs.
- Determine if a prolonged period of declining demand and economic uncertainty increases the risk that inventory may not be sold above its net realizable value.
- Consider if further write-downs of inventory value are needed.

Asset Impairment

Prolonged periods of economic decline may be considered an adverse condition that requires an assessment of impairment of long-term assets. An asset is considered impaired when the company is unable to recover the carrying value, either by selling it or using it in operations.

Impairment of long-lived assets – Assets, such as property and equipment, should be assessed and tested for recoverability as recent events could indicate that the carrying amount may not be recoverable.

Loans receivables - Assess whether they are considered collectible or whether an allowance should be recorded for a portion or all of the amount outstanding. In the worst case scenario, you may need to also consider a potential write-off.

Investments – Impairment of investees, such as subsidiaries and joint arrangements, require an

YOUR CUSTOMERS MAY BE EXPERIENCING SIMILAR BUSINESS CHALLENGES WHICH INCREASES YOUR RISK OF FINANCIAL LOSS RESULTING FROM THEIR INABILITY TO PAY.

assessment of potential impairment at the end of each reporting period. The impact of COVID-19 may result in significant adverse changes in the expected timing or the amount of future cash flows from the investments requiring the recognition of an impairment loss.

Goodwill and intangible assets with an indefinite useful life – Under Canadian Accounting Standards for Private Enterprises (ASPE), goodwill and intangible assets with an indefinite useful life are required to be tested for impairment whenever events or changes in circumstances indicate that the carrying amount may exceed its fair value. Given changing circumstances, an impairment test will likely need to be performed this year. Under International Financial Reporting Standards (IFRS), goodwill and indefinite life intangible assets are required to be tested annually for impairment in any event. However, under both financial reporting frameworks, the results of the annual impairment test may require an impairment loss to be recognized in your current year financials.

Revenue Recognition

If you have customer contracts in place, now is a good time to assess whether there are any contingent losses and/or onerous contracts. In other words, has your company entered into any contracts where the financial burden to fulfill the agreement is greater than the benefit? Assess the likelihood of loss which may negatively impact operational results and financial covenants. Material changes to contracts also need to be considered in terms of performance and delivery to assess if the timing of revenue recognition needs to be altered. If so, what impact does this have on the amount of revenue recognized during the current fiscal year?

Real estate businesses will have to consider the consequences of providing rent relief or modifications to lease agreements to their tenants.

Sales returns and warranty provisions may need to be assessed over a longer period of time due to potential expected delays in order fulfillment. This may also require a more extensive review of product returns subsequent to year end to assist you in estimating potential sales returns. You may also want to revisit your return policies and make modifications as needed. Some businesses, for example, are refusing product returns during the COVID-19 outbreak to help prevent the spread of the virus. Others are extending sales returns periods to their customers as most sales are now on-line and returning items to physical store locations is not possible.

Your Fiscal Year End

If your fiscal year end is March 31, 2020 or later, there will be greater implications with respect to accounting for the impact of COVID-19 as you may need to record for adjusting events in addition to subsequent event disclosures. Fiscal year-ends prior to March 31, 2020 will primarily be subject to subsequent event disclosures only.

Financial Reporting Implications

Covenant Violations

Recording for adjusting events may impact your financial covenants which, in turn, may affect your ability to meet obligations and obtain additional financing. Businesses that default on their debt covenants per their credit facility agreement, provide the creditor a right to accelerate repayment. If at any time during the fiscal year, the company is in breach of its covenants, the accounting standards require that the breach be disclosed in the notes to the financial statements. When a covenant violation occurs, it gives the lender the right to demand repayment. As a result, the debt must be presented as a current liability on the balance sheet unless the lender waives (in writing) the covenant violation and does not demand repayment within the next fiscal year. Given current conditions it's important to closely monitor covenants. Should a breach occur, reach out to your lender, and discuss remediation options. It's best to have these conversations as early as possible.

COMMUNICATION IS KEY. THE BEST REMEDY FOR THESE UNCERTAIN TIMES IS REGULARLY COMMUNICATING WITH YOUR KEY BUSINESS AND FINANCIAL ADVISORS, STAKEHOLDERS, CUSTOMERS AND SUPPLIERS ALIKE.

Discontinued operations

Should you decide to discontinue operations of an unprofitable division or sell-off a product line or service, you are required to separately disclose information pertaining to these discontinued operations in the notes to the financial statements. Comparative figures for the discontinued operations also need to be disclosed.

Going concern

You will need assess if current events represent adverse conditions impacting the company's ability to continue as a going concern. A proactive approach will involve an assessment of adverse conditions and preparing a management plan with steps on how these circumstances will be mitigated. You are strongly encouraged to speak with your financial advisor to discuss the future viability of your company.

A comprehensive assessment and response plan may include:

- Assessing the most vulnerable financial areas expected to be impacted and understanding the effect on financial covenants or lending limits.
- Preparing robust forecasts for a minimum 12-month period, along with cash flow projections, to anticipate potential shortfalls.
- Forecasting potential covenant breaches in advance of year end.

Being proactive and raising these issues with your lender may be an opportunity to discuss remediation plans and revisit details of your credit agreements. Explore whether your lender is willing to make any short-term modifications or concessions to assist with the current economic burden many businesses are facing.

The COVID-19 pandemic has caught many by surprise and the new reality will take time to adjust to. It's important to assess the accounting and financial reporting implications on your business in advance of your company's fiscal year end. Discuss your financial and operational results, impacts on covenants and related financing with your advisors and share your plans to support your company's viability. This will preempt any unexpected surprises and put your business in a better position to weather the storm.

COVID-19 RESOURCES HUB

Visit our COVID-19 Resources hub for the latest information on Canadian and US government programs as well as helpful resources for business owners, including free webinars.

fullerllp.com/covid-19-resources/

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