ASPE Accounting Insights

Accounting considerations related to COVID-19

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Introduction

The coronavirus pandemic ("COVID-19") is affecting economic and financial markets, and most industries are facing challenges associated with the economic conditions resulting from efforts to address it. Many companies in the travel, hospitality, leisure, and retail industries have seen sharp declines in revenues due to regulatory and organizational mandates (e.g., "work from home" mandates, school closures) and voluntary changes in consumer behaviour (e.g., "social distancing").

As the pandemic continues, companies are experiencing conditions associated with a general economic downturn. This includes, but is not limited to, financial market volatility, deteriorating credit, liquidity concerns, broad declines in consumer discretionary spending, increasing inventory levels, reductions in production because of decreased demand, layoffs and furloughs, and other restructuring activities. While government interventions continue to occur in an attempt to lessen the economic impact, the prolonged conditions could have a significant negative impact on a company's financial results.

This publication discusses certain key considerations related to conditions that may result from COVID-19 for companies applying Accounting Standards for Private Entities ("ASPE") in Part II of the *CPA Canada Handbook*.

The significance of the individual issues discussed below will vary by industry and by company, but we believe that the following topics will be the most pervasive and difficult to address.

- *Preparation of forecast cash flow estimates*—The use of forecast information is pervasive in a company's assessment of, among other things, the company's ability to continue as a going concern and impairment of assets. Unique complexities associated with preparing forward-looking information in the context of the pandemic and economic downturn include the following:
  - There is an extremely wide range of possible outcomes, resulting in a particularly high degree of uncertainty about the ultimate trajectory of the pandemic and the path and time needed for a return to a "steady state."
  - The associated economic impact of the pandemic is highly dependent on variables that are difficult to predict. Examples include the degree to which governments prohibit business and personal activities, the associated level of compliance by citizens, the degree to which "flattening the curve" is successful, and the nature and effectiveness of government assistance.
  - Each company must then translate the effect of those macro conditions into estimates of its own future cash flows.

Nevertheless, companies will need to do their best to make reasonable estimates, prepare comprehensive documentation supporting the basis for such estimates, and provide robust disclosure of the significant judgments exercised, the key assumptions used and, potentially, their sensitivity to change. When assumptions or estimates are required for more than one purpose (e.g., forecast revenues may be relevant to impairment tests and recognition of future tax assets), consistent assumptions should be used for all relevant estimates.

- *Going concern*—One of the most acute examples of the challenges associated with forecast information is the assessment of going concern. As a result of COVID-19 and its associated effects, companies need to consider whether, in their specific circumstances, they have the ability to continue as a going concern for at least, but not limited to, 12 months from the balance sheet date. Management's assessment of the entity's ability to continue as a going concern involves making a judgment, at a particular point in time, about inherently uncertain future outcomes of events or conditions. This will require management to consider, among other things, (1) the extent of operational disruption; (2) potential diminished demand for products or services; (3) contractual obligations due or anticipated within one year; (4) potential liquidity and working capital shortfalls; and (5) access to existing sources of capital (e.g., available line of credit, government aid).

- *Subsequent events*—It may be challenging for management to determine if a subsequent event is adjusting or non-adjusting in a marketplace that is extremely volatile and in which major developments occur daily (e.g., announcements of government stimuli and restrictions) and the stock market's daily reaction to new information. Although companies may not have all facts "on hand" at the financial statement date, once such facts are gathered, an assessment must be made based on conditions as they existed at the date of the financial statements. The financial statements should be adjusted only to reflect subsequent events that provide evidence of conditions that existed at the financial statement date. This will be highly dependent on the financial statement date, the specific circumstances of the company's operations and the particular events under consideration.

- *Recoverability and impairment of assets*—Another example of the challenges associated with forecast information is the impairment testing for non-financial assets (e.g., property, plant and equipment, intangible assets, and goodwill). The impairment test for these assets often requires the development of cash flow projections that are subject to the significant uncertainties noted above.

- *Impairment of trade and other receivables*—Many companies will face customers having difficulty paying amounts owed on a timely basis. Companies will need to revisit allowance for doubtful account estimates and ensure they are updated to reflect the new circumstances.

- *Contract modifications*—Changes in the economic activity caused by the pandemic will cause many companies to renegotiate the terms of existing contracts and arrangements. Examples include revenue contracts, lease agreements, debt agreements, employment contracts, and the terms of many financial assets and liabilities. Companies will need to ensure that the relevant requirements in ASPE are applied.

Companies must carefully consider their unique circumstances and risk exposures when analyzing how recent events may affect their financial statements. Specifically, financial statement disclosures will need to convey the significant effects of the COVID-19 pandemic.

Measurement uncertainty

As a result of the uncertainty associated with the unprecedented nature of the COVID-19 pandemic, companies are likely to face challenges related to selecting appropriate assumptions and providing relevant disclosures in their financial statements. Nevertheless, they are still required by ASPE to develop estimates that underlie various accounting conclusions.

Section 1508, *Measurement uncertainty* addresses disclosure requirements when there is measurement uncertainty arising from items recognized in the financial statements. When the uncertainty is material, the company is required to disclose the nature of a measurement uncertainty including a description of the circumstances giving rise to the uncertainty and relevant information about the anticipated resolution. The company is also required to disclose the extent of the measurement uncertainty. Companies can disclose this variability by disclosing a range of reasonably possible amounts that relate to the estimate or by disclosing the effect of a change in the significant underlying assumptions used to estimate the amount. When reporting in such unsettled times, it is important to provide users of the financial statements with appropriate insight into the company's resilience in the face of the current uncertainty and to understand the key assumptions and judgments made when preparing financial information. Relevant disclosures around material measurement uncertainty might include the:

- availability and extent of support through government support measures that have been announced;

- availability, extent and timing of sources of cash, including compliance with banking covenants or reliance on those covenants being waived;

- duration of social distancing measures and their potential impacts.

There is not a single view on how the COVID-19 pandemic will evolve and its impact on the economy. This lack of consistency makes the need for transparent disclosure of judgments related to measurement uncertainty more important than usual.

Going concern

COVID-19 is disrupting operations of many businesses. Companies will need to consider whether such disruption will be prolonged and result in diminished demand for products or services, or significant liquidity shortfalls (or both) that, among other things, cause management to assess whether the company may be able to continue as a going concern for at least, but not limited to, 12 months from the balance sheet date.

Financial statements are prepared on a going concern basis unless management intends either to liquidate the entity or to cease trading, or has no realistic alternative but to do so. When making its assessment, if management is aware of significant uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, the company must disclose those uncertainties.

In the current situation, the assessment is made more difficult given the uncertainties about the impact of the COVID-19 pandemic, the extent and duration of social distancing measures in effect in many jurisdictions, and the impact on the economy. Management should consider the impact of these matters on the company's specific circumstances, in particular current and expected profitability, debt repayment schedules, and potential sources of replacement financing before it can satisfy itself that the going concern basis is appropriate.

The assessment as to whether the going concern basis is appropriate takes into account events, including COVID-19, after the balance sheet date and up to the date the financial statements are completed. For example, companies with a December 31, 2019 year end that completes their financial statements on June 15, 2020, in making the going concern assessment, management will need to take into account all information available up to June 15, 2020, which is the date of completion of the financial statements. The information to be considered includes government announcements affecting the ability of a company to operate and of any government assistance programs to which the company may be entitled. When management is aware of material uncertainties related to events or conditions that cast a significant doubt on the entity's ability to continue as a going concern, paragraph 17 of Section 1400, *General standards of financial statement presentation*, requires disclosure of those significant uncertainties in the financial statements. The disclosure should be specific to the entity's own situation, for example, explaining how and when the uncertainty may be resolved and its impact on the entity's resources, operations, and liquidity.

Subsequent events

Financial statements are prepared to reflect a company's financial position at the balance sheet date and the operating results and cash flows for a period ended on that date (e.g., 12-month period). Subsequent events are significant events between the balance sheet date and the financial statement completion date that may require adjustments to the financial statements or no adjustment, but disclosures only. Given the economic environment and the likelihood that events may occur rapidly or unexpectedly, companies should carefully evaluate information that becomes available after the date of the financial statements but before the date of their completion (i.e., subsequent events).

Adjusting subsequent events provide further evidence of conditions that existed at the balance sheet date. Non-adjusting subsequent events are indicative of conditions that arose after the date of the financial statements and are not reflected in the recognition or measurement of items in the financial statements, but require disclosure when significant.

With respect to periods ending on or before December 31, 2019, it is generally appropriate to consider that the effects related to COVID-19 on a company are the result of events that arose after the financial statement date since the first documented COVID-19 cases in Canada occurred on January 27, 2020 and the WHO declared a global pandemic on March 11, 2020. As these events indicate conditions that arose subsequent to the financial statement date as opposed to providing further evidence of conditions that existed at the financial statement date, they may require disclosure in the financial statements but would not affect the amounts recognized at the financial statement date.

In Canada, for periods ending on or after March 31, 2020, COVID-19 had arrived and accordingly, it is not COVID-19 in itself that should be considered a "subsequent event" but rather the events and transactions that have resulted due to COVID-19. For example, operation shut-downs, government subsidies, cancellation of contracts, and other events need to be assessed if adjusting or non-adjusting subsequent events. Adjusting events provide further evidence of conditions that existed at the financial statement date and require adjustments to the amounts recognized in financial statements. Non-adjusting events indicate conditions that arise after the financial statement date and require disclosure. This will be highly dependent on the financial statement date, the specific circumstances of the company's operations and the particular events under consideration.

If non-adjusting events will cause significant changes to assets or liabilities in the subsequent period, or will, or may, have a significant effect on the future operations of the company, disclosure is required. At a minimum, the company must disclose the nature of the event and an estimate of its financial effect, when practicable. Estimates carry measurement uncertainty. Therefore, notes in the financial statements should be included to explain the significance of any measurement uncertainties if a material change in recognized amounts is reasonably possible in the near term. It is preferable to provide a range of estimated effects as an indication of impact to not providing any quantitative information at all. However, where the determining of the quantitative effect is not practicable, qualitative description should be provided, along with a statement that such an estimate cannot be made.

Impairment

Impairment of financial instruments (trade receivables and investments)

Generally, financial instruments are measured at cost, amortized cost, or fair value. The following considerations pertain to financial instruments measured at cost or amortized cost. The economic impacts associated with COVID-19 may have adversely affected the value of those financial instruments. For example, many companies will have trade receivables, and COVID-19 can affect the ability of many customers in meeting their payments due. Companies should assess whether there are any indicators of impairment for trade receivables. In practice, the extent of impairment considers the aging of balances, past loss experience, customer-specific information (e.g., bankruptcy) and current economic conditions. At the end of each reporting period, management should assess trade receivables to ensure that they are still reflective of the amount the company can expect to recover. This analysis is required for arm's length receivables as well as related party financial assets. Companies will also need to assess whether the impact of COVID-19 has triggered an impairment indicator for investments measured at cost and determine if there is a decrease in the investment's cash flows, which would require an impairment loss to be recognized on the investment. ASPE also provides guidance on when an impairment loss should be reversed in subsequent periods.

Valuation of inventories

Section 3031, *Inventories,* requires inventories to be measured at the lower of their cost and net realizable value (NRV). NRV is an entity-specific value defined as "the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale." As a result of the pandemic, the NRV of an item of inventory may fall below its cost for many reasons, including a decline in selling prices (e.g., as a result of price concessions offered to customers), or an increase in the estimate of costs to complete and market the inventories (e.g., increased costs to provide protection to employees). In a difficult economic environment, the NRV calculation may be more challenging and require more detailed methods or assumptions. These impacts would also apply to agricultural producers using NRV if they have early adopted Section 3041, *Agriculture* in the measurement of agricultural inventories.

In addition, manufacturing companies may have to reassess their practices for the allocation of fixed overhead costs if production volumes become abnormally low during the period as a result of plant closures or lower demand for their products. ASPE requires that variable production overhead costs be allocated to each unit of production based on the actual units produced. However, fixed overhead costs must be allocated to each unit of production based on the normal capacity of the production facilities. The COVID-19 pandemic may affect manufacturing companies in a number of ways (e.g., shortages of labour and materials or unplanned factory downtime) that, if sustained, may result in an abnormal reduction of a company's production levels. In such circumstances, a company should not increase the amount of fixed overhead costs allocated to each inventory item. Rather, the unallocated fixed overhead costs are recognized as an expense in the period in which they are incurred. If a company applies a "cost of goods sold" presentation, then the costs are included as part of cost of sales.

An entity will also need to consider whether certain costs incurred because of the pandemic can be capitalized. These may include additional storage costs due to delays in the delivery of inventories or costs of repackaging to make goods available in a different market with higher demand. Paragraph 17 of Section 3031 provides the following as examples of costs that should be excluded from the cost of inventories and recognized as expenses in the period in which they are incurred:

a. abnormal amounts of wasted materials, labour, or other production costs;

b. storage costs, unless those costs are necessary in the production process before a further production stage;

c. administrative overheads that do not contribute to bringing inventories to their present location and condition; and

d. selling costs.

Impairment of long-lived assets

Companies will need to assess whether the impact of COVID-19 has potentially led to an impairment of long-lived assets such as property, plant and equipment and certain intangible assets. Financial performance, including estimates of future cash flows and earnings, may be significantly affected by the direct or indirect impacts of the pandemic. Section 3063, *Impairment of long-lived assets* seeks to ensure that a company's assets are carried at a value not more than their fair value. For purposes of recognition and measurement of an impairment loss, a long-lived asset shall be grouped with other assets and liabilities to form an asset group at the lowest level for which identifiable cash flows are largely independent of the cash flows of other assets and liabilities.

ASPE requires management to consider whether impairment indicators exist that indicate the carrying amount of an asset may not be recoverable. Indicators of impairment include external factors such as changes in the business climate that the company operates that could impact the value of the asset. Other indicators are internal factors such as the extent or manner to which, an asset is used or is expected to be used. Some examples include an asset becoming idle, plans to discontinue or restructure the operation to which an asset belongs, or plans to dispose of an asset before the previously expected date.

Factors resulting from the COVID-19 pandemic that indicate that the carrying amount of an asset group may not be recoverable may include (1) a decreased demand for the company's products or services; (2) increased costs/business interruptions due to supply chain issues; (3) cancellations of orders by customers; (4) the need to provide significant concessions to customers; and (5) significant customers experiencing financial difficulties.

When there is an indication of impairment, the testing for the impairment of an asset (or asset group) is a two-step process:

- Step 1—the carrying value of the asset is compared to the estimated *undiscounted* future cash flows from the use and eventual disposition of that asset (or asset group). If the undiscounted cash flows exceed the carrying amount, there is no impairment and step 2 is not required.

- Step 2—If the *undiscounted* cash flows in step 1 are less than the carrying amount of the asset (or asset group), the carrying value of the asset is written down to its fair value and an impairment loss is recorded. If *fair value* is determined using a cash flow model, it would generally be calculated by *discounting* the future cash flows used in step 1. An impairment loss is not reversed if the fair value subsequently increases.

In determining the *future cash* flows, management will be required to make significant judgments. Careful consideration of the cash flow projections, growth rate(s) and interest rate(s) will be critical in terms of the supportability and reasonableness of the calculations given the current market conditions. In particular, the projected future cash flows should be based on what could have reasonably been known at the balance sheet date of the conditions that existed at that date. The cash flows should not reflect the effects of restructuring that are not committed at the balance sheet date as this would be inconsistent with the requirement to determine the future cash flows at the balance sheet date. Similarly, the benefits of government assistance should be reflected as cash inflows only if there is sufficient understanding at the balance sheet date of the government assistance program, so that reasonable supportable estimates can be developed of the amounts to which the company is expected to be entitled. Depending on the range of possible outcomes for these expected government programs, it may be more appropriate to use multiple scenarios and a probability-weighted approach to arrive at management's best estimate of future cash flows, as discussed further below.

Management may determine that using an expected cash flow approach is the most effective means of reflecting the uncertainties of the COVID-19 pandemic in its estimates. This approach reflects all expectations about possible cash flows instead of the single expected outcome. For example, a cash flow might be $100, $200 or $300, with probabilities of 10%, 60% and 30%, respectively, giving an expected cash flow of $220, i.e., ($100 × 10%) + ($200 × 60%) + ($300 × 30%).

For step 2, the *interest rate* used to discount the future cash flows must reflect assumptions that are consistent with those inherent in the estimated cash flows. Otherwise, the effect of some assumptions will be double-counted or ignored. Hence, to the extent that risk and uncertainties about the future impact of the COVID-19 pandemic are not reflected in the projected cash flows of the asset group being tested, they should be reflected in the interest rate applied.

Estimates for fair value can stem from quoted market prices in active markets and prices for similar items. When these sources are unavailable, valuation techniques such as the present value technique can be used for fair value estimations. When using a discounted cash flow model in present value calculations, key principles to bear in mind are:

- Estimated cash flows should reflect the conditions in existence at the balance sheet date reflecting assumptions about the future events and uncertainties that would be considered in deciding whether to acquire an asset or group of assets in an arm's length transaction for cash.

- Estimated cash flows and interest rates should be free from both bias and factors unrelated to the asset or group of assets in question.

- Estimated cash flows or interest rates should reflect a range of possible outcomes, rather than a single most likely, minimum, or maximum possible amount.

- Interest rates used to discount cash flows reflect assumptions that are consistent with those inherent in the estimated cash flows.

- Care should be taken as to the consistency of the data being prepared and compared to avoid double counting or omission of some data.

If information is received subsequent to the balance sheet date, indicating that an asset is impaired, management should consider whether that information is indicative of impairment that existed at the balance sheet date. If the information received after the balance sheet date is not indicative of conditions existing at the balance sheet date, it does not trigger an impairment test. Rather, the information should be disclosed as a non-adjusting subsequent event when it is of such importance that non-disclosure would affect the decisions of users of the financial statements.

Regardless of the outcome of the impairment testing, management must review the estimates of useful life and amortization methods for all long-lived assets and record the impact prospectively.

Information about asset impairment will be critical in helping users of the financial statements understand the impact of the COVID-19 pandemic on a company's financial performance and position. Disclosure of the key assumptions used to determine the future cash flows and, if applicable, fair values, together with a description of management's approach to determining the value assigned to each key assumption, should be provided.

Impairment of goodwill and indefinite-life intangibles

If a company has either goodwill or indefinite-life intangibles, these assets must also be assessed for indicators of impairment. The indicators include significant adverse changes in the business climate, which will likely be an indicator for most companies.

Companies with impairment indicators for goodwill or indefinite-life intangibles will test for impairment under Section 3064, *Goodwill and intangible assets*. There are some key differences to that of impairment for long-lived assets to keep in mind:

- Goodwill and indefinite-life intangibles do not utilize a two-step impairment test. Once impairment indicators are identified, the impairment loss is determined by comparing the carrying amount of the asset to its fair value (i.e., there is no 'undiscounted future cash flow' step).
- Goodwill is assessed at the reporting unit level.
- Indefinite-lived intangible assets are combined into a single unit of accounting for purposes of testing impairment if they are operated as a single asset.
- When goodwill and another asset of a reporting unit are tested for impairment at the same time, the other asset is tested for impairment first and the impairment loss, if any, is recorded before goodwill is tested for impairment.

The discussions above on determining fair value for long-lived assets are equally relevant in the assessment of fair value for goodwill and indefinite-life intangibles.

Covenant violations

Section 1510, *Current assets and liabilities* requires that the current liability classification of long-term debt includes only that portion payable within one year from the date of the balance sheet. Non-current classification of debt is based on facts existing at the balance sheet date rather than on expectations regarding future refinancing or renegotiation. Sustained operating losses and reduced cash flow will increase the risk that companies will violate their financial covenants. Management should consider how covenant violations impact the classification of the related liabilities at the financial statement date. Paragraph 14 of Section 1510 requires that long-term debt with measurable covenant violations on or before the balance sheet date be classified as a current liability unless:

a. the creditor has waived, in writing, or subsequently lost, the right, arising from violation of the covenant at the balance sheet date, to demand repayment for a period of more than one year from the balance sheet date; or

b. the debt agreement contains a grace period during which the debtor may cure the violation and contractual arrangements have been made that ensure the violation will be cured within the grace period;

and a violation of the debt covenant giving the creditor the right to demand repayment at a future compliance date within one year of the balance sheet date is not likely.

Debt modifications

Companies experiencing liquidity challenges may seek to renegotiate the terms of its borrowings or other liabilities resulting in amendments to existing agreements. When such modifications occur, the company must assess whether they are considered extinguishments (i.e., if the renegotiated debt *differs substantially* from the old debt) or not.

Transactions are considered extinguishments either when there is a change in the creditor and the original debt is legally discharged, or when the terms of renegotiated debt result in a difference in the net present value of the instrument's cash flows of at least 10 percent (the "10 percent test").

When a transaction is considered an extinguishment, the existing financial liability is derecognized and the new liability is recognized at fair value. Any resulting gain or loss is recognized in net income.

However, when the modification is not substantial (i.e., less than 10 percent), no gain or loss is recognized; rather the fees and transaction costs related to the renegotiation are adjusted to the carrying amount of the debt instrument and amortized over the remaining term of the renegotiated debt.

Revenue recognition

Business disruptions associated with COVID-19 may result in changes in circumstances experienced by both the company and its customers. For example, many companies may be experiencing declining sales and customers are experiencing financial difficulties. Management should assess any impact of such disruptions on its revenue recognition policies.

Under Section 3400, *Revenue*, a company should recognize revenue only when collectability is reasonably assured. Because of the significant uncertainty associated with the effects of COVID-19, the ability of customers to make payments may be significantly affected. For example, if customers are experiencing liquidity issues, companies will need to carefully evaluate whether those circumstances are short-term in nature or whether collectability is no longer reasonably assured for that customer. In such cases where revenue is no longer reasonably assured, revenue may have to be recognized on a cash basis for that customer.

A company should also consider the impact to revenue recognition if there are changes to the agreed upon terms and conditions in the arrangement, e.g., if it provides refunds, rebates, or price concessions to either help its customers or incentivize them to purchase its goods and services. There may also be disruption due to temporary closures that impact the provision of services by the company. Accordingly, companies will need to assess the impact of these business disruptions on their revenue recognition policies.

A company that is in the construction industry and recognizes revenue on long term contracts over a period of time based on a cost-to-cost basis or on a percentage of completion basis, may need to reassess the amount of revenue being recognized and determine whether any changes are required for measuring progress. In addition, if due to COVID-19, total contract costs are expected to exceed total contract revenue, the company should determine if a loss should be recognized immediately in the period.

Government assistance

In response to the COVID-19 pandemic, the federal and provincial governments have been implementing programs to help companies that are experiencing financial difficulty. Section 3800, *Government assistance* requires a company to consider the specific circumstances surrounding its entitlement to government assistance in order to determine the appropriate accounting treatment, including when the benefit is recognized. Government assistance such as grants related to expenses or revenues is included in the determination of net income when the related expense or revenue is incurred, or if the assistance relates to capital assets, when the amortization is recorded. Government support in the form of a forgivable loan is treated in the same way as a grant that does not need to be repaid unless an entity fails to comply with previously agreed upon conditions. The forgivable loan is recognized as a grant when the company becomes entitled to receive it and not at the time the loan is forgiven.

For government assistance to be recorded at a balance sheet date before the funding is received, the company must have reasonable assurance that it has complied with and continues to comply with all the conditions.

The presentation of government assistance in the income statement depends on the circumstances. The alternatives available are: (1) present expenses net of assistance; (2) present the assistance as a deduction from aggregate expenses; or (3) present the assistance as revenue. The choice should be applied consistently to similar grants.

Due to COVID-19, the federal government has created a program where a bank or credit union will be able to provide interest-free loans of up to a limit to eligible businesses. If the loan is repaid by a certain date, a certain percentage will be forgiven. If the loan is not repaid by that date, the remaining balance will be converted to a fixed term loan with interest. If a company is eligible for this type of program, there are a number of issues that they need to think about. Firstly, under ASPE, when a company receives an interest-free loan from a government agency, under Section 3856, *Financial instruments*, in the absence of evidence to the contrary, the difference between the fair value of the loan and the cash received is accounted for as a government grant. Therefore, a company will have to apply judgment to determine if there is a government grant component due to the interest-free feature. Secondly, a company will have to assess whether it is entitled to receive the forgivable loan component with respect to the timing of recognition. Thirdly, if at some point down the road, the company determines that it will be unable to repay the loan in full such that the grant is not forgiven, then the company will have to apply the guidance under ASPE for the repayment of the government grant.

Disclosure is required of the amount(s) of government assistance received or receivable, the accounting policy for recognition, the relevant terms and conditions, and for forgivable loans, the unforgiven balance and information relating to the assistance or forgiveness.

Leases

As a result of COVID-19, many companies are experiencing significantly reduced consumer traffic in retail stores and shopping areas, or indefinite closures due to quarantine measures and other government directives. The potential lease accounting considerations for lessees and lessors is discussed below. Please refer to "Standard-setting impacts" for additional information on the future amendments to Section 3065, *Leases* due to COVID-19.

Lessee accounting

Under Section 3065, for an operating lease, lease rentals are recognized on a straight-line basis over the lease term. Lessees that are receiving rent concessions or other economic incentives such as rent deferrals from their landlords will need to assess if there has been a modification of the lease. Under ASPE, for an operating lease, there is limited guidance on the accounting for lease modifications and therefore, it is unclear whether modifications that do not include changes to the lease term such as rent concessions or rent deferrals are also within the scope of this paragraph and accordingly, a company will have to apply judgment in these circumstances.

Lessor accounting

ASPE requires lessors to assess whether there are any indications that each direct financing, sales-type lease, operating lease receivables (the lease asset), or group of similar lease assets, is impaired. Impairment could occur as a result of business closures, supply chain disruption, or other consequences of the pandemic that negatively affect the future cash flows expected to be derived from the lease asset. Examples of impairment indicators of lease assets that may occur due to the pandemic include: significant financial difficulty of a lessee or adverse change in the environment that the lessee operates; default or delinquency in payment; and/or concessions being granted to a lessee.

As discussed above, some lessors are providing rent concessions to ease the economic burden of COVID-19 on lessees. ASPE does not provide any guidance on the accounting for lease modifications for lessors. Similar to the discussion above, given the lack of guidance under ASPE, lessors will have to apply judgment to determine how to account for rent concessions.

Restructuring costs and related liabilities

Companies may be considering or implementing restructuring plans to mitigate their exposures associated with unforeseen consequences of COVID-19. Actions may include immediate measures to reduce their workforce through temporary employee layoffs or longer-term actions such as the sale or closure of part of its business. Examples of restructuring costs may include contract termination costs; costs to consolidate facilities or centralize operations; and/or costs to relocate employees.

ASPE does not have specific guidance for accounting for "restructuring" activities. Instead, companies must assess whether such costs meet the definition of a liability and consider other sections of ASPE for specific items (see Termination benefits below if the restructuring involves the termination of employees).

Paragraph 28 of Section 1000, *Financial statement concepts,* defines liabilities as obligations of an entity arising from past transactions or events, the settlement of which may result in the transfer or use of assets, provision of services, or other yielding economic benefits in the future. Liabilities have three essential characteristics:

- they embody a duty or responsibility to others that entails settlement by future transfer or use of assets, provision of services or other yielding of economic benefits, at a specified or determinable date, on occurrence of a specified event, or on demand;
- the duty or responsibility obligates the entity leaving it little or no discretion to avoid it; and
- the transaction or event obligating the entity has already occurred.

In determining how to account for specific activities related to a restructuring, companies must start by identifying the nature and characteristics of each proposed action that is being considered. Such costs should be recognized when the event obligating the entity has already occurred and the company has little or no discretion to avoid it. This determination may involve judgment and will not necessarily result in the same timing of recognition for all costs merely on the basis that they are part of one plan.

Companies also need to consider whether their restructuring plans include the disposal of long-lived assets for which the accounting is specifically addressed in Section 3475, *Disposal of long-lived assets and discontinued operations.*

Employee-related costs (excluding termination benefits)

Companies may be offering new programs to the workforce to manage their response. Similar to the previous section, where ASPE does not have guidance for a specific employment-related benefit, the timing of recognition of such costs is based on when the definition of a liability has been met. Some examples occurring during this pandemic include:

- *Salary continuation*—Some companies may offer to compensate employees even though they are not actively working during a temporary shutdown period, keeping the right to call employees back to work as necessary and preventing employees from taking up work elsewhere. The company has the discretion to ask some or all of its employees to return to work when the conditions will permit and revert to normal working arrangements and remuneration. Therefore, in these circumstances, the costs of salary continuation should be recognized over the continuation period and should not be accrued at the outset.
- *Stay bonus*—Some companies may offer special bonuses to employees as a reward for them working in these difficult conditions. Payments of these bonuses may be contingent on the employees continuing to provide services until a certain date. In such circumstances, the expense to be recognized in the period in which the service has been rendered (assuming the entity has no discretion to avoid it and the amount can be reasonably estimated). The fact that some employees may leave without receiving payments offered under the bonus plans is reflected in the measurement of the liability. It is not appropriate to defer recognition of the liability until the employee completes the entitlement period.

Termination benefits

Companies that are facing permanent work place reductions may offer benefits to the impacted employees as part of a termination package. ASPE provides guidance in Section 3462, *Employee future benefits* specifically for *special termination benefits* (as opposed to those that are contractually determined). The guidance determines when an accrual for such costs based, in part, on whether such plans are voluntary or involuntary. The company should recognize a liability based on the following requirements:

- *Voluntary terminations* of employment are recognized as a liability and an expense when an employee accepts the offer and the amount of the benefits can be reasonably estimated.
- *Involuntary terminations* of employment are recognized as a liability and an expense in the period in which:
  - management, having the appropriate level of authority, approves and commits to the plan and establishes the benefits;
  - the plan is communicated to employees in sufficient detail to enable them to determine the type and amount of benefits they will receive;
  - the plan specifically identifies the target level of reduction in the number of employees, the job classifications or functions, and their locations; and
  - the period of time to complete the plan of termination indicates that significant changes to the plan of termination are not likely.

  Management should carefully assess whether each criterion is met at the balance sheet date before recording an accrual for the costs of involuntary termination plans.

Pension plans

Companies with *defined benefit* plans will be impacted by COVID-19. Section 3462, *Employee future benefits* requires a company to determine the amount of the defined benefit obligation and the fair value of plan assets at each balance sheet date. ASPE provides companies an option to measure the defined benefit obligation using an actuarial valuation prepared for either accounting purposes or funding purposes, and regardless of the type used, the valuation must be prepared once every three years, at a minimum. For those years when a full actuarial valuation is not prepared, a roll-forward (referred to as an extrapolation) is used to estimate the defined benefit obligation. However, Section 3462 stipulates that an actuarial valuation would be required earlier than the three-year timeframe when a "significant event" takes place. Examples of "significant events" include a plan settlement or curtailment (employees are terminated or stop accruing service) or certain plan amendments. ASPE is explicit that a significant change in the interest rate does not trigger a requirement for a new actuarial valuation, but the standard is silent beyond this. Companies are encouraged to involve a professionally qualified actuary for support in measuring the obligations and judgment should be applied in determining whether a full actuarial valuation should be performed in the current year despite not being explicitly required under ASPE.

Under ASPE, plan assets are measured at fair value. Pension plans may hold significant amounts of assets that do not have an active market, such as certain real estate assets or infrastructure assets that may become more illiquid, making their valuation more complex. Appropriately determining the fair value of such assets is important in the determination of the funded status of a defined benefit plan.

There are other consequences of defined benefit plans that may need to be considered in this environment. For example, a plan deficit or other funding requirements can result in large cash outflows and, in some circumstances, this could affect the ability of an entity to operate as a going concern (see Going concern). In addition, plans to terminate employees who are members of a defined benefit plan may trigger a curtailment and should be discussed with the company's actuary.

Income statement presentation

Paragraph .04(m) of Section 1520, *Income statement*, requires separate disclosure, either in the income statement or notes to the financial statements, of transactions or events that are not expected to occur frequently over several years, or do not typify normal business activities of the entity. The impact of COVID-19 may give rise to significant expense items for many companies. Management will need to consider whether separate disclosure of the costs related to COVID-19 is required in the income statement or notes. Some of the impacts will give rise to discrete losses or expenses, such as those related to impairment losses. However, there may also be other impacts such as an overall decrease in a company's profitability due to lower revenue and/or the continuance of salaries and other expenses while operations are closed. Accordingly, the identification of the impacts of COVID-19 on a company's performance and whether separate disclosure should be included requires judgment. Any additional information that is necessary to explain the impact of COVID-19 should be included in the notes to the financial statements.

Management should consider whether the headings or subtotals remain relevant and useful to an understanding of the company's financial performance. For example, if a company presents an operating income line, it would not be appropriate to exclude items that are operating in nature outside of operating income.

Income tax

Section 3465, *Income taxes* provides a policy choice in the accounting for income taxes: the taxes payable method or the future income taxes method. When a company applies the *future income taxes method*, the impacts of COVID-19 should be considered. For example, a reduction in net income or the occurrence of losses, coupled with a reduction in forecasted income, could result in a reassessment of whether it is probable that the company's future tax assets, if any, can be recovered. Such assessments will be particularly challenging in situations in which the changes in current and projected future profitability actually result in, or are expected to result in, cumulative losses and the company has not had a stable earnings history before the impacts of COVID-19. If declining earnings or impairments generate losses, a company will need to evaluate whether there is sufficient income of the appropriate character to fully realize the related future tax asset.

In addition, the rate and tax base used to calculate the future tax balances should reflect the manner in which the company expects, at the end of the period, to recover the asset or settle the liability. Accordingly, companies will need to consider whether strategies considered to address the challenges brought by the COVID-19 pandemic have an effect on the recognition and measurement of future tax amounts.

As permitted by Section 3465, companies may have not recognized future tax liabilities for taxable temporary differences associated with subsidiaries, and interests in joint arrangements, because they control the timing of the reversal of the temporary difference and it has been probable until now that the temporary difference will not reverse in the foreseeable future. Conversely, it may have recognized future tax assets for deductible temporary differences associated with such investments because it was probable that the temporary difference would reverse in the future (and it was probable that the future tax asset could be recovered). It may be appropriate to reconsider these conclusions, if as a result of COVID-19, the company changes its intent with respect to the repatriation of undistributed earnings in an investee to help with liquidity issues.

Other topics

Transparency of financial statement disclosures

The overall objective of the financial statements is to communicate information that is useful to investors, creditors, and other users. For information to be meaningful to investors, it must not only meet the "minimum disclosure requirements" but should clearly and transparently convey the key events and transactions that have had an impact on the company.

To assist in achieving the above-stated objective, boilerplate disclosures related to COVID-19 should be avoided. A company should tailor its disclosures to its unique and specific circumstances to explain to its users how COVID-19 has affected its financial performance including estimates and judgments applied. For example, Section 3856, *Financial instruments* requires disclosures of the risks and uncertainties for each significant risk arising from financial instruments, including the nature and extent of risks to which the company is exposed at the end of the reporting period, as well as any concentrations of risk. For each significant risk, the financial statements should reflect how the pandemic has changed their exposures and concentrations of risk. There may be a concentration of risk to particular industries such as tourism that require additional discussion in the COVID-19 environment. Users may be particularly focused on understanding the company's liquidity risk (i.e., the risk that a company will encounter difficulty in meeting obligations associated with financial liabilities), and management should ensure such disclosures have been carefully considered to ensure they reflect all relevant facts and circumstances specific to the company.

Insurance recoveries

Companies that incur losses stemming from the COVID-19 pandemic may be entitled to insurance recoveries through business interruption or other insurance. For example, losses associated with increased asset impairments or litigation may be considered insured losses. It may also be the case that a company can seek reimbursement of part or all of the expenditure from another party, for example, via an insurance contract arranged to cover a risk, an indemnity clause in a contract, or a warranty provided by a supplier. When it is likely that such amounts will be received, Section 3290, *Contingencies*, requires disclosure in the financial statements, however such amounts are only recorded when payment is received.

Subsidiaries

Section 1591, *Subsidiaries* determines which investments of a company are subsidiaries through the assessment of control, being the continuing power to determine an enterprise's strategic operating, investing, and financing policies without the co-operation of others. The COVID-19 pandemic may give rise to events that could change who controls the enterprise. For example, when a lender's rights under a loan agreement are enforceable upon default or breach of a loan covenant by the borrower, in some circumstances the lender will have obtained control of the enterprise. Judgment will be necessary to determine if such rights are merely protective and are not considered to give the lender power over (and consequently control of) the enterprise.

Categorization of foreign operations

Section 1651, *Foreign currency translation* separates foreign operations into two categories: *integrated or self-sustaining*. The accounting treatment results in gains and losses arising from the foreign currency translation of a self-sustaining foreign operation to be recognized in a separate component of shareholder's equity instead of being recognized in net income. A company that has previously determined that one of its foreign operation is "self-sustaining" may need to reassess whether that conclusion is still appropriate. For example, a company that plans to undergo restructuring because of the COVID-19 pandemic may need to reassess whether foreign operations that had previously been determined to be "financially and operationally independent" will remain that way.

Hedge accounting

ASPE permits a narrow scope of transactions to be eligible for hedge accounting, should a company choose to apply hedge accounting. When a hedge relationship pertains to an anticipated transaction in a foreign currency or an anticipated purchase or sale of a commodity, the company should assess whether that anticipated transaction is still probable. If the anticipated transaction is no longer probable, or if the hedged item ceases to exist or the critical terms of the hedging item no longer match, the company must discontinue hedge accounting.

Stock-based compensation

Companies that provide stock-based compensation will need to consider if the probability that vesting conditions for stock-based payments with performance conditions will continue to be met. Section 3870, *Stock-based compensation and other stock-based payments* requires companies to recognize compensation expense based on the best estimate of such performance conditions. For example, if an award contains a performance condition that affects vesting (such as an award that vests if a certain growth in profit is met) and it is not expected that the performance condition will be satisfied due to COVID-19, compensation costs should be adjusted to reflect the expected or actual outcome of the performance-related conditions until the vesting date.

In addition, companies may decide to modify the terms or conditions of an equity-settled award as a result of COVID-19. For example, a change in the fair value-based measure, vesting conditions, or classification of the award. As a result of the modification, the company should record an additional cost for any incremental value provided (if the modification increases the fair value of the awards or additional awards are granted).

Standard-setting impacts

The Accounting Standards Board recently announced that due to the COVID-19 pandemic, they are deferring the effective dates of all previously announced amendments to ASPE by one year. This announcement impacts changes that were originally to be effective for years beginning on or after January 1, 2020, including amendments to Section 3856, *Financial instruments* related to both the classification of retractable or mandatorily redeemable shares issued in a tax planning arrangement and financial instruments in a related party transaction and changes to risk disclosures. These amendments will have significant impact on some private companies, and that impact will now be deferred until the year beginning on or after January 1, 2021. Other amendments impacted include changes to Section 3400, *Revenue* and the new Section 3041, *Agriculture*, now both deferred to January 1, 2022. Early adoption of each of these amendments continues to be permitted.

In addition, at its July 2020 meeting, the AcSB received feedback from its Private Enterprises Advisory Committee on implementation questions that have been raised during the COVID-19 pandemic relating to lease accounting, impairment, employee future benefits, and government assistance. This feedback included the Committee's recommendations about whether any standard setting or additional implementation support is needed for these issues. The AcSB decided to issue an exposure draft to amend Section 3065, *Leases*, to provide relief for both lessees and lessors on accounting for rent concessions in light of the COVID-19 pandemic. The exposure draft is expected to be issued in September 2020. The AcSB will discuss the proposals in the exposure draft and the timeline at its future meetings. The AcSB decided that no standard setting is needed on the other issues at this time but it will continue to provide implementation support through resources on its website. Private companies should monitor current developments as they progress.

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