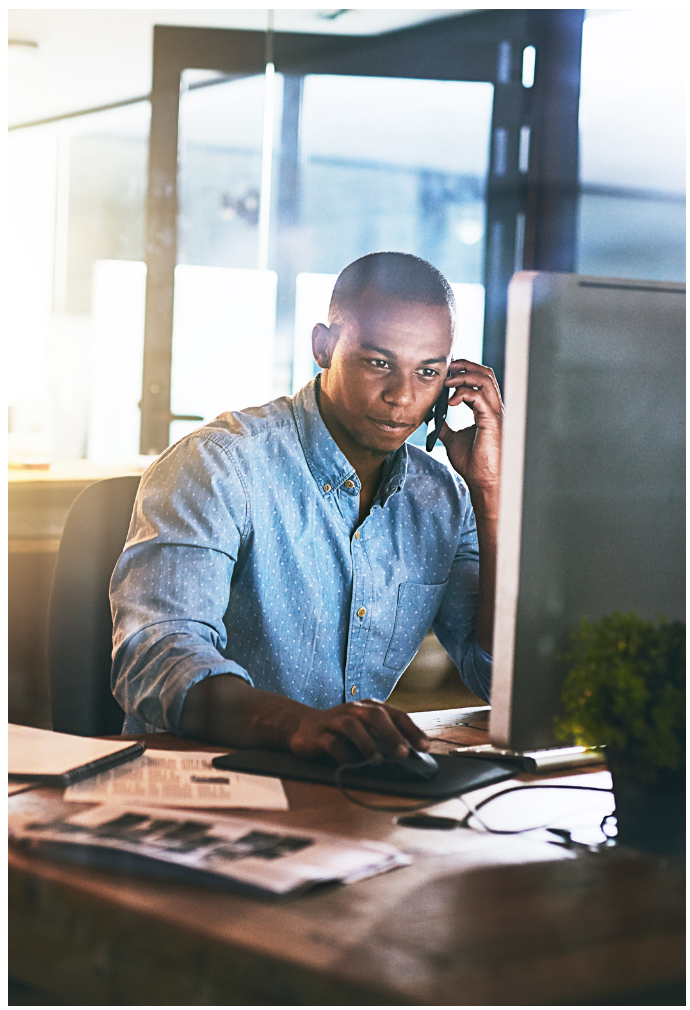
The Canada Emergency Wage Subsidy: Understanding the risks

With the application process for the Canada Emergency Wage Subsidy (CEWS) under way, many Canadian-based employers are looking to this program for support to balance their cash flow and keep their employees working during the COVID-19 pandemic.



However, like most tax legislation, the CEWS is complex—presenting Canadian employers with scenarios that require judgment and decisions that create risk. In the short time since the rules were introduced, finance teams across the country have raised questions around eligibility at a pace far greater than the Department of Finance has been able to answer.

In this article, we look at some of the risk areas you should consider, such as:

- Appreciating the importance of Generally Accepted Accounting Principles ("GAAP") to the CEWS
- Attesting the CEWS claim
- Reliability of monthly reporting
- Measurement of "qualifying revenue"
- Audit risk and penalty exposure

This article does not attempt to address all aspects of the CEWS claim calculation. For a detailed discussion on the mechanics of the claim, including discussion around "eligible remuneration", please refer to Grant Thornton's CEWS document.

Appreciating the importance of Generally Accepted Accounting Principles ("GAAP") to the CEWS

Unique to the CEWS is the definition of "qualifying revenue". With certain exceptions, revenue and expenses are generally measured under the accrual method for purposes of computing income under the Federal Income Tax Act (the Act) and the framework supporting this understanding has been defined through numerous court decisions, Canada Revenue Agency ("CRA") rulings, technical interpretations and academic research. As the Act generally focuses on the taxation of "profit", there is limited jurisprudence and CRA interpretation solely focused on "revenue". Thankfully, the CEWS legislation does reference how revenue should be determined.

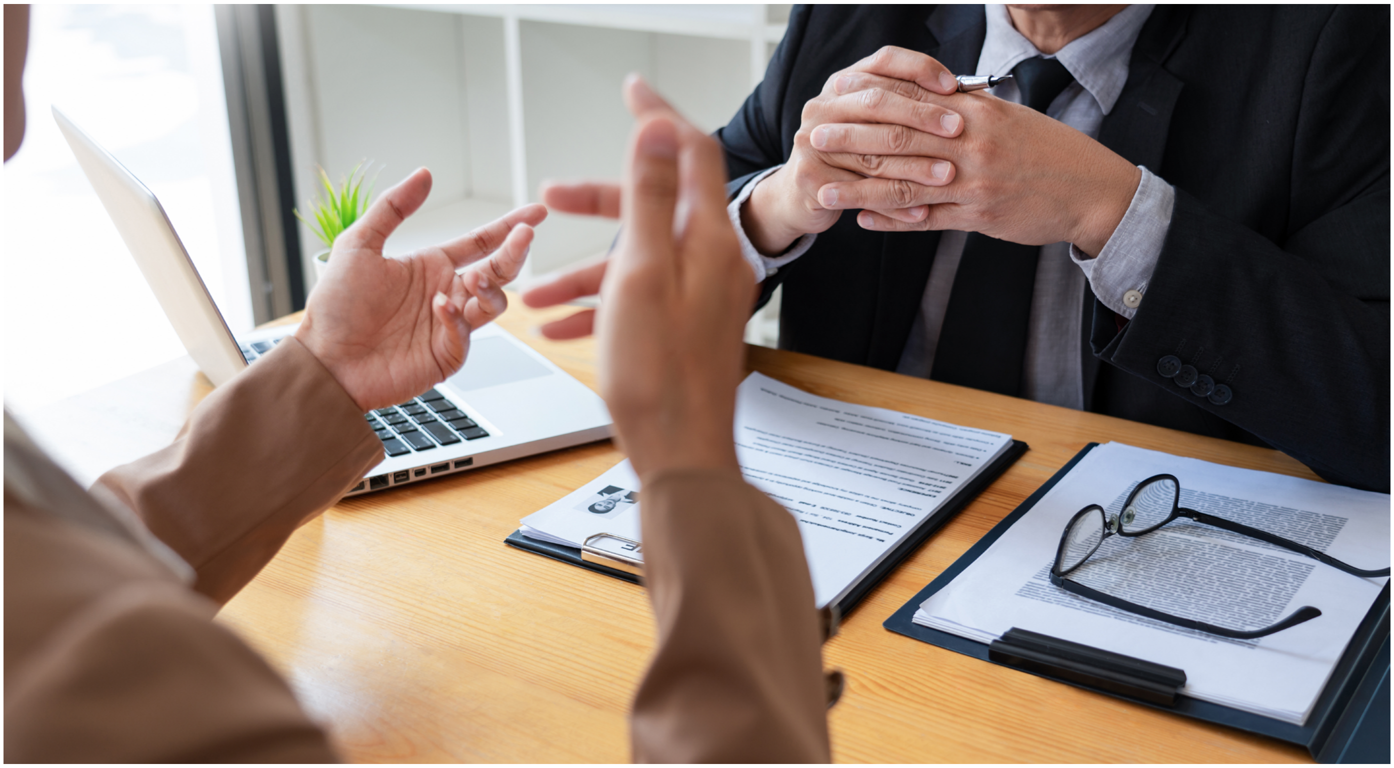
"Qualifying revenue" under CEWS legislation is defined as "the inflow of cash, receivables or other consideration" arising in the ordinary activities of the eligible entity in Canada.[1] The legislation also states that the entity is to determine revenue in accordance with its normal accounting practices. The definition points out that, in addition to the sale of goods and rendering of services, the "use by others of resources of the eligible entity" would also be included in "qualifying revenue". Excluded from the definition are extraordinary items and amounts derived from persons or partnerships not dealing at arm's length with the eligible entity (an election to accommodate this non-arm's length restriction does exist in certain instances[2]).

1 Subsection 125.7(1)
2 Subsection 125.7(4)

The CRA generally views "normal accounting practices" as being compliant with Generally Accepted Accounting Principles or GAAP. IFRS (International Financial Reporting Standards) and ASPE (Accounting Standards for Private Enterprise) are Canada's two official reporting frameworks for profit oriented businesses, and in most cases, the CRA would view IFRS or ASPE financial statements as having followed "normal accounting practices".[3] The CRA has also indicated that it will accept US GAAP as a method of supporting a taxpayer's tax filings, but the taxpayer must still consider if the result provides an accurate picture of income for purposes of the Act.[4]

Canada's courts have made it clear that while GAAP is a "well accepted business principle" for the purposes of computing income, it is an interpretive aid and, for purposes of the Act, a taxpayer is required to demonstrate that it has shown an accurate picture of income.[5] If revenue is either accrued or omitted in accordance with GAAP and what is believed to be well accepted business principles, the CRA could propose an adjustment if it can demonstrate an alternative presentation that provides a more accurate picture. It is important for CEWS claims to be supported by an appropriate analysis and conclusion of the components of revenue recognized, particularly if there is a risk that an alternative view could prevail.

3 ITTN 42
4 2011-0403641E5
5 *Canderal Limited v. The Queen*, 98 DTC 6100



Attesting the CEWS claim

To claim the CEWS, the employer must be a "qualifying entity" which, among other criteria, requires that the application is attested to (i.e. that it is complete and accurate) by an individual having "principal responsibility" for the financial activities of the entity.[6]

While the CEWS is a very important subsidy to Canadian business, it's just one tool that CFOs and other individuals having "principal responsibility" may have at their disposable to secure working capital during the COVID-19 business closure. As such, these individuals may struggle to confirm that their businesses are fully compliant with the nuances of this subsidy.

For certain Canadian public companies, securities regulations require the CEO and CFO to certify the design and operating effectiveness of their internal controls over the financial reporting environment. For these companies, recording a benefit due to a material CEWS claim does require an appropriate level of internal control so the process of claiming the subsidy does not impair the CEO's and CFO's ability to certify the internal control environment. This makes it important to build the appropriate level of review, approval and technical oversight into the CEWS claim process to support public companies' obligations under securities law. Failure to institute these controls and processes could have negative consequences to the company under law.

6 Subsection 125.7(1)

Reliability of monthly reporting

Most of the employers claiming CEWS will be using unaudited financial information in support of the claim. For publicly listed entities and other regulated entities, internal controls are likely established, which may give reasonable comfort that the monthly numbers are fairly presented. However, for many Canadian companies, monthly reporting is not formulized and typically would not be provided to or relied upon by external lenders or investors in its entirety. Either way, a finance team looking to claim the CEWS should review the following areas:

Manual journal entries

Manual revenue accruals or other adjustments should be identified, understood and, if applicable, reversed. Many claims will be made by pulling the revenue sub-ledger detail, which may not necessarily capture the appropriate revenue for the period in question. Often, manual adjustments are necessary to account for cut-off adjustments, rebates or other measurement adjustments. Additional examples include adjustments related to percentage-of-completion, deferred revenue, straight-line rent accruals, etc. In the case of cut-off adjustments, these accruals may require reversal during the period where the actual customer billing is posted to the revenue sub-ledger.

Cut-off

With the recent business disruption, companies may be at risk of posting shipments and other deliverables in a period that does not coincide with the realization of the revenue. For Canadian income tax purposes, the test for the timing of revenue recognition is generally consistent with the timing which supports the recognition of revenue under GAAP. Presumably, the CRA will apply the same test in considering eligibility for the CEWS.

Complex measurement

For many Canadian companies, the measurement of revenue is complex. Assumptions may be included within revenue around variable consideration—such as performance bonuses, rights of return, etc.—but nonetheless are aligned with the underlying financial reporting framework. For purposes of measuring "qualifying revenue", these assumptions should be reviewed and supported to confirm that the measurement of revenue on a monthly basis is fairly stated.

Without a doubt, companies claiming the CEWS should make sure their revenue is fairly measured in accordance with the established financial reporting framework, and, in accordance with acceptable commercial practices. Furthermore, the assumptions and application of this framework should be consistent between the current period and the relevant benchmark. Failing to properly capture required revenue adjustments to align the tested revenue with the underlying recognition policy could result in the entity relying on an overstated benchmark or understated actual for March, April or May 2020. This could potentially result in making a CEWS claim in error. Conversely, failing to capture these adjustments could see an eligible employer erroneously concluding that it is ineligible.

Measurement of "qualified revenue"

Revenue recognition is a complex area of GAAP, but some finance teams experience more complexity than others in this area. Here are a few common scenarios that companies may run into:

Service business with performance obligations satisfied over time

For many businesses, revenue is recognized over the period that it is delivered, so for a given month, the recognition of this revenue may not match the economic receipt of either cash or receivables. Instead, it would reflect the performance of the obligation. For businesses that have continued to satisfy their performance obligations but have seen significant disruption to their business and future orders or contracts, the impact to revenue may not be seen immediately. These employers may want to elect under the "cash method" to align their qualified revenue calculation with the economic reality of their business (as defined by the Act).[7] Failing to consider this election could preclude an otherwise-qualifying entity from filing a CEWS claim.

One caveat is that, while an election to apply the cash method may make sense for a service business, many Canadian employers have a service business that complements the delivery of physical product. Under CEWS legislation, an election under the cash method must apply to ALL revenue supporting the claim and for each month that the CEWS is claimed. Consideration will need to be given to the aggregate change in revenue and cash receipts for the relevant period versus the chosen benchmark to determine which method is most appropriate and puts the company in the best position to benefit from the CEWS.

Use of percentage of completion method or completed contract

For companies in the construction or large fabrication space, the percentage of completion method is a common way to recognize revenue. Construction companies with long-term, high risk projects may alternatively use the completed contract method, but only when it has been determined that reasonable estimates are unavailable to support percentage of completion.

While the mechanics of these calculations can be quite complicated, the methods can be described as follows:

- Percentage of completion involves the recognition of revenue and the resulting gross profit over time as progress is made with respect to the completion or delivery of the underlying product
- Completed contract defers this recognition until the project is complete, as the name implies

However, for monthly reporting, the application of these methods may be automated and/or based on project cost assumptions which are not updated until the end of the quarter or fiscal year. If you use percentage of completion or completed contract and are applying for CEWS, your revenue must be appropriately stated in accordance with these standards.

The CRA has a history of challenging the appropriateness of a taxpayer's revenue recognition policy, and the timing of revenue recognition is a common theme in income tax audits. Canadian courts have also weighed in, recently, with the Federal Court overturning a previous Tax Court decision to accept the taxpayer's chosen method of revenue recognition (albeit for purposes of determining taxable capital under the Act).[8] The CRA has also historically made its views known with respect to when it is appropriate for contractors, for example, to use completed contract, although it has traditionally showed a bias against this method.[9]

For entities that believe there could be uncertainty within their monthly presentation of contract revenue, care should be made to confirm that the reported revenue is in accordance with their established accounting policy, using up-to-date assumptions. In addition to perhaps providing a more accurate depiction of the economic impact on these entities' due to COVID-19, electing to use the cash method may facilitate a more robust determination of qualified revenue that is more easily supported in the event of a CRA audit.

7 Paragraph 125.7(4)(e), election requires application of cash method under Subsection 28(1)
8 *The Queen v Bombardier Inc.*, 2012 FCA 46
9 Interpretation Bulletin 92R2 (Archived)

Rebates

Rebates are often issued by manufacturers and distributors to economically reward customers who surpass a certain volume threshold of purchases.

Most accounting systems and general ledgers will track these rebates as a separate account, then group either as a contra account to revenue or within operating expenses. Furthermore, the determination of these rebates may be undertaken during a quarter or fiscal closing and may not be accrued monthly. If they are accrued, the assumptions may not be current if the expectation is that they will be adjusted as required in support of a financial reporting period. For Canadian income tax purposes, rebates are reported under the accrual basis providing they represent a commercial obligation and are not general reserves.

If you have a customer rebate program and you plan to apply for CEWS, there are several things to keep in mind. First, if you intend to net rebates against revenue, it must be consistent with your established accounting policy within the underlying financial reporting framework. If supported, confirm that you are appropriately capturing the correct rebate accounts against your revenue when arriving at "qualified revenue". Second, if you traditionally adjust your rebates at the end of the quarter or fiscal year, make sure the accruals are consistent with your current customer trade arrangements and have been fairly reported.

Audit risk and penalty exposure

It is generally expected that the CRA will be tasked with reviewing and auditing CEWS claims, which will be issued under a self-assessment system. As part of the CEWS legislation, the Act was amended to include the CEWS provisions within the standard statute of limitations.[10] As such, the CRA's window to audit the subsidies received aligns with the normal reassessment period of three years for Canadian Controlled Private Corporations and four years for publicly listed companies and those that are foreign controlled. Given the economic challenges of 2020, several CEWS claims may simply reduce net operating losses available for carry-forward or carry back. In these instances, your CEWS claim would be open to audit until the commencement of the normal reassessment period, which will start with the mailing of a notice of assessment or reassessment for the taxation period in which the loss is claimed.

CEWS legislation also amends the Act to include subsidy claims within the penalty provision for "false statements or omissions", which allows the CRA to assess a penalty up to 50 percent of the amount of CEWS received if the attestor is deemed to have made a false statement or omission, or acted in a manner that amounted to gross negligence.[11] In certain cases, significant personal penalties may also apply to the individual attesting to the CEWS claim (often, these penalties are not covered by an employer's errors and omissions insurance).

Finally, the CEWS legislation does include an anti-avoidance provision which will disqualify an entity from its original receipt of the CEWS if it is found to have entered into a transaction or participate in an event that has the effect of intentionally reducing the respective 2020 revenues. However, for this provision to apply, it must be reasonable to conclude that one of the main purposes of the transaction was to cause the entity to be eligible for the CEWS.[12] If an entity is assessed under this anti-avoidance provision, the Act imposes a penalty of 25 percent to CEWS amounts received which are deemed to have been "overpayments".[13]

For any CEWS amounts repaid due to an audit adjustment, an employer should anticipate the CRA charging interest to the entity at the prescribed rate. Consistent with the existing provisions of the Act, this interest would not be deductible for income tax purposes.[14]

10 Paragraph 152(1)(b)

11 Subsection 163(2)
12 Subsection 125.7(6)
13 Subsection 125.7(6), subsection 163(2.901)
14 Subsection 163(3)

How can we manage our business risk?

The CEWS was unquestionably put in place to provide much-needed financial support to those businesses most impacted by the current COVID-19 pandemic and resulting business closures. Canadian companies should consequently look at this program from every angle to determine if they are eligible to participate. At the same time, they must make sure that their entitlement is robust and supported. CEWS legislation is new and unprecedented, and the individuals responsible for submitting the CEWS application should work closely with those responsible for financial reporting.

Additional care should be taken by Canadian companies with external reporting obligations. That's because the existence of a CEWS claim of a material nature can place additional obligations on management and the external auditor to support the company's entitlement to this claim.

If you need help claiming the CEWS, Grant Thornton is here for you. We can work with you to compile your supporting documentation, conduct the necessary financial analyses or specified work around the determination of "qualified revenue" and develop supported conclusions for your claim. We can also advise you on the supporting documentation you are required to retain under federal law.

Visit our COVID-19 Hub for timely information and resources and connect with your Grant Thornton advisor to learn more.

Grant Thornton

grantthornton.ca

Audit | Tax | Advisory

© 2020 Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd. All rights reserved.

About Grant Thornton LLP in Canada

Grant Thornton LLP is a leading Canadian accounting and advisory firm providing audit, tax and advisory services to private and public organizations. We help dynamic organizations unlock their potential for growth by providing meaningful, actionable advice through a broad range of services. Grant Thornton LLP is a Canadian member of Grant Thornton International Ltd, whose member and correspondent firms operate in over 100 countries worldwide.