

Impact of COVID-19 on Preparation and Presentation of Financials Statements – From Auditor’s Point of View

Background

In this difficult environment, each regulatory body is releasing relief measures and guidelines for easing out the impact of COVID 19. On the financial and compliance front, announcements have been flowing from the Government authorities in the form of deferment of statutory due dates or relaxation in payment terms to overcome the financial crisis being faced due to lock-down.

Institute of Chartered Accountant of India (ICAI) has come out with its guidelines for care to be taken by the PREPARER and AUDITOR of the financial statements. This guidance from the ICAI addresses the common issues which would be encountered on account of COVID 19 while preparing the financial statements and its audits and how they should be addressed.

For better understanding of the quarterly and year-to date financial results, separate disclosure may be presented in financial statement for aggregate loss incurred due to COVID 19 being irregular and not ordinary in nature.

We have bifurcated the guidelines for the preparers and auditors into two sections. In this note, we have focused from the viewpoint of the Auditor’s. Separate note on Company’s Viewpoint is also prepared and published in our website.

I. Guidelines for the AUDITORS of the financial statements

1. Impact of corona virus on audit of financial statements

• **Revision in risk assessment and materiality**

Evaluation of additional risks on account of operational disruption, contractual non-compliance, liquidity & working capital issues, possibility of fraud, etc. will require revision in risk assessment and in calculation of materiality.

• **Year-end physical verification**

Considering the lock-down, it will not be possible for the entities to conduct physical verification of inventory and cash balances as on the cutoff date of 31st March 2020. The auditor shall perform alternate audit procedures to ensure the appropriateness of the stock levels / cash balances as on the reporting date.

• **External confirmations**

Auditor shall perform alternate audit procedures if inadequate / no responses are received from external parties for balance confirmation.

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- **Assessment of significant accounting estimates and assumptions**

Considering the fact that lot of estimation and assumptions will be involved for factors such as impairment of assets, provision for onerous contract, contractual penalties, etc., auditor shall be skeptical in assessment of such estimates and assumptions made by management or its expert. The auditor shall obtain written representation from the management.

- **Assessment of Going concern**

In the current pandemic of prolonged operational disruption, the financial position of the entities would have been unfavorable. Auditors' should evaluate its impact on the going concern of the entity and discuss this with those charged with governance.

- **Group audit**

In case of audit of consolidated financial statements where the component(s) auditors are located in severely affected places, the principal auditor may perform alternative methods like video conferencing, filing detailed questionnaire, etc. for conducting the audit. It shall consider the impact of COVID 19 on the financial statement of its components.

- **Other reporting requirements in the audit report**

1. The auditor shall evaluate that whether the impact of disruption could be a Key Audit Matter (KAM).
2. In regard to its responsibilities relating to other information, the auditor shall consider the disclosures made by the Company for COVID-19 risks in its financials / annual report.
3. In case of reporting under Internal Financial Controls (IFC), additional considerations might be required to be considered before drawing an opinion.

In our view,

- auditors should prepare a separate set of questionnaires for management to identify such risks involved in each of the critical areas and measures taken to mitigate such risks and revisit the level of materiality.
- auditors will have to assess the risk involved in each client based on the size, volume and classification of inventory at year end. Auditors should formally communicate to the management about the alternate steps which would be taken during the course of audit and auditor's representative will not be present during the year end physical count.
- auditor shall examine subsequent receipts / payments, underlying documents for transactions during lock-down period. Confirmations from related parties should be insisted.
- additional precaution should be taken by the auditors and emphasis may be added in the audit report.
- audit steps should include assessment of risk and ability of the management to fulfill its obligations / current liabilities in next 12 months.

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- early warning should be given by the component auditor to principal auditor for matter like deadlines which cannot be fulfilled, any material adjustments, etc.

II. Impact Concerning Auditing Standards

Principles of Specific Standards on Auditing used in this Advisory

Areas which require special attention of auditors in current scenario are cited below along with reference to relevant Standards on Auditing (SAs):

- Identifying and Assessing the Risk of Material Misstatements and Materiality in Planning and Performing an Audit (SA 315, Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment & SA 320, Materiality in Planning and Performing an Audit)
 - Assessing Financial Impact and their Reasonable Estimation (SA 540, Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures)
 - Valuation of Inventory on a date other than date of financial statements i.e. 31st March 2020 (SA 501 Audit Evidence - Specific Considerations for Selected Items)
 - Subsequent Events or Events after Reporting date (SA 560, Subsequent Events)
 - Going Concern (SA 570(Revised), Going Concern)
 - Evaluation of Work of Management's Expert (SA 500, Audit Evidence)
 - Written Representations (SA 580, Written Representation)
 - Auditor's Opinion, [SA 700(Revised), Forming an opinion and Reporting on Financials Statements, SA 705(Revised), Modification to the opinion in the Independent Auditor's Report, and SA 706(Revised), Emphasis of matter paragraph in the Independent Auditor's Report]
 - Reporting on Key Audit Matters (SA 701, Communicating Key Audit Matters in the Independent Auditor's Report)
 - Internal Control Considerations
 - External Confirmations (SA 505, External Confirmation)
 - Risk of Fraud (SA 240, The Auditor's Responsibilities relating to Fraud in an Audit of Financial statements)
- i. Identifying and Assessing the Risk of Material Misstatements and Materiality in Planning and Performing an Audit**

The outbreak of COVID-19 can have a number of potential issues for entities,

- Particularly entities that operate in geographies that are significantly exposed to the outbreak.
- There could also be impact on those entities whose vendors/ bankers/ suppliers/ service providers are in geographies that are exposed.

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The outbreak will also pose increasing risks and potentially have accounting implications for all entities with exposure to broader economic downturn and decline in financial markets.

Due to the above conditions like, entities and auditors would have to evaluate additional risks arising from the following areas:

- Operational disruption resulting in any changes to the business model arising from significant drop in demand, reduced customer base, disruption in supply chain, employee's absence or work from home, geographical implications of group operations, public lock down etc.
- Contractual non-compliance resulting in contractual breaches, additional security requirements or stressed asset valuations.
- Liquidity and working capital issues given the reduced/ impaired ability to service debt or replenish working capital requirements due to possible lower cash flows.
- Asset valuations – downward asset valuations may trigger legal and compliance issues or lead to liquidity challenge.

In applying SA 315 - Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment, the auditor should consider the implications of the above matters when obtaining an understanding of the entity and its environment, in light of its objectives, strategies and other business risks.

Revision as the Audit Progresses

- The auditor shall revise materiality for the financial statements as a whole/particular class of transactions, account balances or disclosures) in the event of becoming aware of information during the audit that would have caused the auditor to have determined a different amount (Ref: Para. A13)
- If the auditor concludes that a lower materiality for the financial statements as a whole/ for particular classes of transactions than that initially determined is appropriate, the auditor shall determine whether it is necessary to revise performance materiality, and whether the nature, timing and extent of the further audit procedures remain appropriate.”

ii. Assessing Financial Impact and their Reasonable Estimation

The financial statements have various items which would have been affected by the outbreak of COVID-19, a detailed list of them has been mentioned in the Accounting Advisory.

In addition to the detailed list of items of financial statements mentioned in the aforesaid Advisory, specific accounting issues could arise in the following areas

- Impairment of Goodwill, Property Plant and Equipment, Intangible Assets and Valuation & impairment of receivables, loans and advances.

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- Valuation of defined benefit plans and obligations – due to significant changes in employee strength or de-valuation of underlying plan assets.
- Stock compensation performance conditions and obligations.
- Contractual penalties.
- Employment termination benefits.
- Insurance recoveries related to business interruptions.
- Onerous contract provisions
- Allowance for expected credit losses

The above items are likely to have significant accounting estimates to be made by the management. Significant assumptions including projected cash flows, used in these accounting estimates may be affected by the impact of COVID19.

The auditor should use procedures as prescribed by SA 540, Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures to check whether:

- The accounting estimates, including fair value accounting estimates, in the financial statements, whether recognised or disclosed, are reasonable; and
- Related disclosures in the financial statements are adequate.

The above procedures include how management has assessed the effect of estimation uncertainty or the risk assessment and audit evidence supporting these accounting estimates and related disclosures that may be affected by the impact of COVID-19 on the business of the entity and the economic environment.

iii. Valuation of Inventory on a date other than date of financial statements i.e. 31st March 2020

- It may not be practicable for most of the business entities to conduct physical verification of inventory as on the date of the financial statements i.e. 31st March 2020.
- The auditor must plan procedures depending on the underlying circumstances wherein the inventory count date could be advanced prior to the year- end or deferred to a date after the year-end.

The auditor would need to comply with the procedures given in Paragraphs 5 and 7 read with Paragraphs A9 to A14 of SA 501 cited below:

“5. If physical inventory counting is conducted at a date other than the date of the financial statements, the auditor shall, in addition to the procedures required by paragraph 4, perform audit procedures to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded. (Ref: Para. A9-A11)”

Relevant matters for consideration when designing audit procedures to obtain audit evidence about whether changes in inventory amounts between the count date, or dates, and the final inventory records are properly recorded include:

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- Whether the perpetual inventory records are properly adjusted.
- Reliability of the entity's perpetual inventory records.
- Reasons for significant differences between the information obtained during the physical count and the perpetual inventory records.

Attendance at Physical Inventory Counting Is Impracticable (Ref: Para. 7) A12.

- If attendance at physical inventory counting is impracticable, the auditor shall perform alternative audit procedures to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory.
- If it is not possible to do so, the auditor shall modify the opinion in the auditor's report in accordance with SA 705(Revised). (Ref: Para. A12-A14)

The matter of general inconvenience to the auditor, however, is not sufficient to support a decision by the auditor that attendance is impracticable.

Alternative audit procedures, for example inspection of documentation of the subsequent sale of specific inventory items acquired or purchased prior to the physical inventory counting, may provide sufficient appropriate audit evidence about the existence and condition of inventory.

iv. Subsequent Events or Events after Reporting date

The Responsibilities of the auditor for the subsequent events i.e. events between the date of financial statements and the date of auditor's report as per SA 560 are as follows:

“Events Occurring Between the Date of the Financial Statements and the Date of the Auditor's Report

- The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified. (Ref: Para. A6)
- The auditor shall perform the procedures required by paragraph 6 so that they cover the period from the date of the financial statements to the date of the auditor's report, or as near as practicable thereto.
- The auditor shall take into account the auditor's risk assessment in determining the nature and extent of such audit procedures, which shall include the following: (Ref: Para. A7-A8)
 - a) Obtaining an understanding of any procedure management has established to ensure that subsequent events are identified.
 - b) Inquiring of management and, where appropriate, those charged with governance as to whether any subsequent events have occurred which might affect the financial statements. (Ref: Para. A9)
 - c) Reading minutes, if any, of the meetings, of the entity's owners, management and those charged with governance, that have been held after the date of the financial statements and

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inquiring about matters discussed at any such meetings for which minutes are not yet available. (Ref: Para. A10)

- d) Reading the entity's latest subsequent interim financial statements, if any

When, as a result of the procedures performed as required by paragraphs 6 and 7, the auditor identifies events that require adjustment of, or disclosure in, the financial statements, the auditor shall determine whether each such event is appropriately reflected in those financial statements.”

v. Going Concern

- COVID-19 is resulting in significant operational disruption and presents an existential threat for many businesses. Entities and audit teams need to consider the implications on the assessment of going concern and viability in the financial report and whether it will result in prolonged operational disruption/result in failure of business.
- Auditors will need to consider whether the threat to liquidity as a result of supply/demand disruption presents a material uncertainty to the going concern status for the 12 months look forward period.
- SA 570(Revised) also requires auditors to consider events that may cast significant doubt on the entity's ability to continue as a going concern beyond the period of management's assessment.
- Audit teams should robustly assess the going concern and viability risks relating to COVID-19 threat in compliance with SA 570(Revised). This includes evaluating whether there is adequate support for the assumptions underlying management's assessment and the consistency of these assumptions across the entity's business activities.

As per paragraph 5 of SA 570(Revised), Going Concern

The following factors are relevant to judge an entity's ability to continue:

- The degree of uncertainty associated with the outcome of an event or condition increases significantly the further into the future an event or condition or the outcome occurs. For that reason, most financial reporting frameworks that require an explicit management assessment specify the period for which management is required to take into account all available information.
- The size and complexity of the entity the nature and condition of its business and the degree to which it is affected by external factors affect the judgment regarding the outcome of events or conditions
- Any judgement about the future the is based on information available at the time at which the judgement is made.

Responsibilities of the Auditor

The auditor's responsibilities relating to going concern are mentioned in Paragraphs 6 & 7 of SA 570(Revised), Going Concern which are cited below:

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- The auditor's responsibilities are to obtain sufficient appropriate audit evidence regarding, and
- Conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements, and
- To conclude, based on the audit evidence obtained, whether a material uncertainty exists about the entity's ability to continue as a going concern.

These responsibilities exist even if the financial reporting framework used in the preparation of the financial statements does not include an explicit requirement for management to make a specific assessment of the entity's ability to continue as a going concern.

vi. Evaluation of Work of Management's Expert

As per paragraph 8 of SA 500—Audit Evidence,

“When information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary, having regard to the significance of that expert's work for the auditor's purposes: (Ref: Para. A34- A36)

- Evaluate the competence, capabilities and objectivity of that expert; (Ref: Para. A37-A43)
- Obtain an understanding of the work of that expert; and (Ref: Para. A44- A47)
- Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion. (Ref: Para. A48)

vii. Written Representations

- As per SA 580, the auditor should obtain written representations from the management regarding the various estimates and assessments made by the management.
- The written representations should be exhaustive, containing the occurrence, method of measurement, completeness of transactions recorded and the disclosure of financial impacts in the financial statements.
- Auditors need to assess whether any specific representations may be required to be obtained from the Management in relation to Managements' assessment of impact from the ongoing outbreak of COVID-19 on the financial statements for the year ending March 31, 2020 as well as for the reasonable foreseeable future.

viii. Auditor's Opinion

The overall objectives of an auditor as per SA 200—Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing, are as follows:

- To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and

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- To report on the financial statements, and communicate as required by the SAs, in accordance with the auditor's findings.

Auditor should form an opinion on the financial statements considering the principles enunciated in SA 700(Revised), SA 705(Revised), SA 706 (Revised).

Since in the current scenario there are high probabilities of going concern being affected, existence of material uncertainties relating to going concern, the principles enunciated in SA 570(Revised) also need to be considered.

Particularly paragraphs 21 to 24 which prescribe manner of reporting in different situations. The auditor needs to carefully assess the situation applying professional judgement and professional skepticism and report accordingly.

ix. Reporting on Key Audit Matter

The auditor would need to comply with the procedures given in Paragraphs 9 (read with Paragraphs A18 to A26) of SA 701 cited below:

The auditor shall determine, from the matters communicated with those charges with governance, those matters that required significant auditor attention in performing the audit. The auditor shall take into account the following: (Ref: Para. A9-A18)

- Area of higher assessed risk of material misstatement, or significant risks identified in accordance with SA 315. (Ref: Para. A19-A22)
- Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty. (Ref: Para. A23-A24)
- The effect on the audit of significant events or transactions that occurred during the period. (Ref: Para. A25-A26)

x. Internal Control Consideration

In case of companies, where the auditors have to issue a Report on the Internal Financial Controls Over Financial reporting under Clause (i) of Sub section 3 of Section 143 of the Companies Act, 2013, because of the impact of COVID-19, there could be additional considerations that need to be considered as below:

- Companies may need to implement new internal controls or modify existing internal controls over financial reporting.
- Evaluate whether any of the controls is not operating effectively on account of absence of concerned person due to illness/quarantine/ working from home/isolation/travel inaccessibility.
- Identify alternate controls.
- Company's ability to close financial reporting process in time.

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- Company's ability to design and implement controls related to selection and application of Generally Accepted Accounting Principles (GAAP) for accounting and disclosure issues arising from COVID-19.

xi. External Confirmation

- SA 330 also indicates that external confirmation procedures may assist the auditor in obtaining audit evidence with the high level of reliability that the auditor requires to respond to significant risks of material misstatement, whether due to fraud or error
- SA 240 indicates that the auditor may design confirmation requests to obtain additional corroborative information as a response to address the assessed risks of material misstatement, whether due to fraud at the assertion level.

Results of the External Confirmation Procedures

Reliability of Responses to Confirmation Requests

If the auditor identifies factors that give rise to doubts about the reliability of the response to a confirmation request, the auditor shall obtain further audit evidence to resolve those doubts. (Ref: Paragraphs 11-12 of SA 505 reproduced below)

- If the auditor determines that a response to a confirmation request is not reliable, the auditor shall evaluate the implications on the assessment of the relevant risks of material misstatement, including the risk of fraud, and on the related nature, timing and extent of other audit procedures. (Ref: Para A17)

Non-Responses

In the case of each non-response, the auditor shall perform alternative audit procedures to obtain relevant and reliable audit evidence. (Ref: Para A18-A19 below)

Examples of alternative audit procedures the auditor may perform include

- For accounts receivable balances – examining specific subsequent cash receipts, shipping documentation, and sales near the period-end.
- For accounts payable balances – examining subsequent cash disbursements or correspondence from third parties, and other records, such as goods received notes.

The nature and extent of alternative audit procedures are affected by the account and assertion in question.

A non-response to a confirmation request may indicate a previously unidentified risk of material misstatement. In such situations, the auditor may need to revise the assessed risk of material misstatement at the assertion level, and modify planned audit procedures, in accordance with SA 315

