# Issues & developments in Audit due to Impact of COVID-19

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## Virtual CPE Meeting Hyderabad Branch of SIRC of ICAI

August 21, 2021

## …And Covid struck us

The elephant is still in the room

# Impact on audit of financial statements
(not exhaustive)

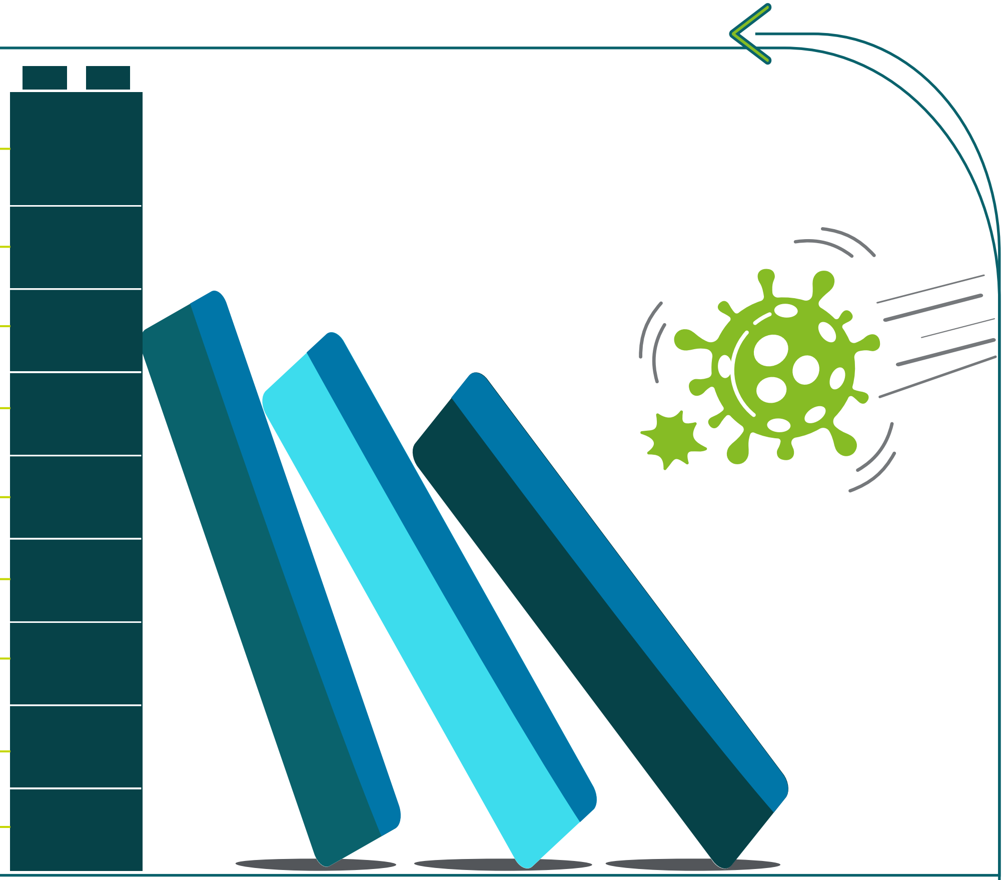
*Ask the why*

*Smell test*

**COVID – 19 – a clear evidencing of consideration**

Professional Skepticism

- Engagement Risk
- Audit planning
- Fraud risk, related parties
- Materiality
- Risk of Material Misstatement
- Internal controls
- Cyber security
- Inventory existence
- Group audits
- Audit evidence
- Analytical procedures
- Confirmations
- Going concern
- Judgements and estimates
- Subsequent events
- Written representations
- Communicating with TCWG
- Notes and disclosures
- Key audit matters
- Audit opinion



Refer to the ICAI and AASB Guidances on COVID-19

# Soundings from the press

# From the Press

**How COVID-19 will affect financial reporting**
To mitigate the effects of the Covid-19 pandemic at a time of book closures, companies would have to prepare for unexpected financial developments
*BusinessLIne May 4, 2020*

**Covid impact on the financial statements of businesses**
Along with modifying future forecasts, companies will also have to reassess their profit and loss account to factor in Covid-related changes
*BusinessLIne April 23, 2020*

**Going concern assessment in the Covid-19 environment**
Rather than leave it to the judgment of the management and auditors, it would be better if companies made assessments based on a common template of assumptions laid down by the regulators
*BusinessLIne May 15, 2020*

**View: Auditors need to demonstrate professional skepticism**
Finance teams in corporate India and their auditors are currently dealing with two completely different challenges. On the one hand they are facing personal challenges arising out of the brutal second wave of the COVID-19 pandemic across India. On the other, they are still trying to deal with the year end financial reporting and audits
*The Economic Times, April 30, 2021*

## What changed

And all of these continue to be relevant

# Fundamentals

## Infrastructure and data confidentiality

# Remote Audit Process - Fundamentals : Infrastructure

## Prepare and organize

- Uninterrupted internet connectivity to all engagement team members
- Adequate training to engagement team members to enable use of virtual audit tools
- Setting up clear timelines and obtaining commitments from stake holders
- Identifying stakeholders from client IT for resolving technology related challenges


## Monitor and deliver

- Use of virtual audit tools throughout the audit for planning, collaboration and monitoring
- Engagement partner-led virtual briefings with the full audit engagement team (including IT specialists) frequently to address audit issues and challenges
- Frequent virtual meetings with members of senior management on audit progress and issues for resolution
- Use of secure platforms to transfer audit evidence

# Remote Audit Process – Fundamentals : Data Confidentiality

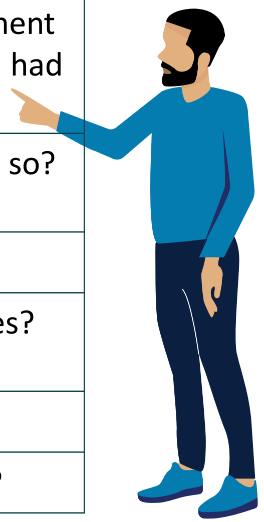

**Remember** In view of remote working environment, data confidentiality has become all the more important

# Fundamentals

## Interactions with Management

# Management interactions – Some proactive questions

| S. No. | Potential questions |
|---|---|
| 1 | How has COVID 19 impacted the financial condition and results of operations? In light of changing trends and the overall economic outlook, how do you expect COVID 19 to impact your future operating results and short, medium and long term financial condition?<br>Do you expect that COVID 19 will impact future operations differently than how it affected the current period? |
| 2 | How has COVID-19 impacted your capital and financial resources, including your overall liquidity position and outlook? |
| 3 | Has your cost of or access to capital and funding sources, such as revolving credit facilities or other sources changed, or is it reasonably likely to change? Have your sources or uses of cash otherwise been materially impacted? |
| 4 | Is there a material uncertainty about your ongoing ability to meet the covenants of your credit agreements? If a material liquidity deficiency has been identified, what course of action has the company taken or proposed to take to remedy the deficiency? |
| 5 | Do you anticipate any material impairments (e.g., with respect to goodwill, intangible assets, long-lived assets, right of use assets, investment securities), increases in allowances for credit losses, restructuring charges, other expenses, or changes in accounting judgments that have had or are reasonably likely to have a material impact on your financial statements? |
| 6 | Have you experienced challenges in implementing your business continuity plans or do you foresee requiring material expenditures to do so? Do you face any material resource constraints in implementing these plans? |
| 7 | Do you expect COVID-19 to materially affect the demand for your products or services? |
| 8 | Do you anticipate a material adverse impact of COVID-19 on your supply chain or the methods used to distribute your products or services? Do you expect the anticipated impact of COVID-19 to materially change the relationship between costs and revenues? |
| 9 | Will your operations be materially impacted by any constraints or other impacts on your human capital resources and productivity? |
| 10 | Are travel restrictions and border closures expected to have a material impact on your ability to operate and achieve your business goals? |



# Fundamentals

Audit Committee asks

# Communications with Those Charged with Governance

## What do  Audit Committees want to Know*

**Risk Assessment :**

- How have the pandemic and associated economic factors influenced the auditor's risk assessments for the current year's audit?
- How has the auditor considered the relevant economic factors that could affect the company's ability to continue as a going concern?
- How has the auditor assessed risks of material misstatement related to the company's technology systems, including relevant cyber threats, and how has it addressed those potential risks?

**Fraud Procedures:**

- How did the auditor identify and assess the risks of material misstatement due to fraud, and how were appropriate audit responses designed and implemented?
- Did the COVID-19 pandemic influence the nature, timing or extent of procedures the auditor performed to address the risk of material misstatement due to fraud? If so, how?

**Key Audit Matters (KAM)**

- Did the COVID-19 pandemic affect the auditor's determination as to whether matters were identified as a KAM (i.e., involved especially challenging, subjective or complex judgment)? If so, how?

**Other Auditors**

- Did restrictions on travel and in-person interactions in 2020 create challenges for supervision and review of work performed by other auditors? If so, how were these challenges addressed?

## Communication with Those Charged with Governance : Some pointers

- Changes to risk assessment and impact of the pandemic
- New controls that were identified by the Management on account of remote working conditions and their operating effectiveness
- Enhanced substantive procedures on account of the pandemic (for example where export receivables are secured by LC, making enquiries as to the financial stability of the foreign bank that has issued the LC, request for confirmation from banks on the unused credit limits to assess liquidity positions)
- Procedures performed for physical verification of inventory and compliance with SA 501
- Significant unobservable inputs used in fair valuation and the sensitivity analysis performed by the management
- Going concern assessment : sensitivities performed by the management
- Subsequent events
- Significant disclosure in the financial statements on account of the pandemic
- Any key audit matters reported as a result of the pandemic
- Impact of the pandemic on the audit report
- How was the remote audit performed
- Steps taken to maintain confidentiality of data

*Adapted from PCAOB staff paper April 2021

**A detailed overview**

And all of these continue to be relevant

# Materiality

# Materiality (SA 320 Materiality in planning and performing the audit)

**Objectives of the auditor:**

The objective of the auditor is to apply the concept of materiality appropriately in planning and performing the audit.

**Revision as the audit progresses:**

The auditor shall revise materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes 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 (or amounts) initially

If the auditor concludes that a lower materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures) 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.

# Materiality (SA 320 Materiality in planning and performing the audit)

## Should the impact of Covid-19 impact the way materiality is determined?

- When profit before tax from continuing operations is volatile other benchmarks may be appropriate
- A change in benchmark because of Covid-19 not to result in an increase in materiality
- Avoid “normalised” measures
- Avoid “averaged” measures
- For example, materiality based on revenue may have to be revisited based on actual revenue achieved post-lockdown. Materiality based on profits may also need to be revisited based on the actual profits achieved by the entity. There could be circumstances when the originally budgeted profit actually turned into a loss due to the impact of the pandemic

**Materiality is a judgement, it is not a computation – document the rationale for the judgement**

# Risk Assessment

# Identifying and Assessing the Risk of Material Misstatement (SA 315, Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment)

Objectives of the auditor:

The objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement. This will help the auditor to reduce the risk of material misstatement to an acceptably low level.

| ACTIONS | AUDIT TEAM CONSIDERATIONS |
|---|---|
| **Perform fraud risk assessments that incorporate entity and industry specific considerations of COVID-19** | • Impact of COVID-19 on the business could be adverse<br>• This could result in a pressure on the management to achieve budgeted results<br>• Consequently, increasing the risk of fraud in the financial statements to a higher level<br>• Auditors to exercise higher degree of professional skepticism and perform extended procedures, as applicable to address fraud risk factors<br>Auditors must be particularly mindful of the heightened risk of fraud and comply with the guidance provided by SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" |

# Identifying and Assessing the Risk of Material Misstatement (SA 315, Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment)

| ACTIONS | AUDIT TEAM CONSIDERATIONS |
|---|---|
| **Determine how COVID-19 specific risk factors influence the identification and assessment of risks**<br> | • **Entity and environment risk factors —** Supply chain disruptions (for e.g., a recent scenario of non-availability of containers resulting in an increased cost of purchase) or loss of customers resulting in reduction in the overall business. Downward asset valuations may trigger legal and compliance issues or lead to liquidity challenge<br>• **Risk factors specific to management's estimates —** Volatility in business and the impact of COVID-19 on business and valuation assumptions to be considered while completing the risk assessment of management estimates. Assumptions may no longer be based on historical data due to the impact of the pandemic. For example : in a retail industry the projections based on number of stores to be opened could possibly be impacted on account of the pandemic and the number of stores based on historical data may not be relevant any more<br>• **Internal controls risk factors, including risk factors specific to management's use of outsourced service providers —** Understand the impact of:<br>  • Remote working<br>  • Change in user access rights<br>  • Cyber security breaches<br>  • Business disruptions<br>  • Third party service providers<br>Some examples of changes in controls: (i) Physical review of documents before approving a payment may now be performed electronically (ii) A control performer who approves certain transactions in the ERP application may no longer be able to access the ERP due to remote working conditions |

# Identifying and Assessing the Risk of Material Misstatement (SA 315, Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment)

## Considerations relating to IT risk assessment

Some points that auditors may consider while assessing the risk relating to the IT environment

- Business continuity plan
- Changes to the IT environment to support remote working – how prepared is the entity
- Changes to user access
- Increase privileged accesses
- Will there be vulnerability issues such as risk of hackers
- Segregation of duties
- Change management
- Service organisation
- Increased demand for IT resources (increased number of tickets and service issues)

# Identifying and Assessing the Risk of Material Misstatement (SA 315, Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment)

## Considerations relating to Cyber Security Breach

- Significant increase in cyber security breaches
- **Ransomware** is a type of malware that prevents or limits users from accessing their system, either by locking the system's screen or by locking the users' files until a ransom is paid. This is the most common attack currently impacting clients at this time.
- Is there any impact on the financial reporting and financial statements on account of the breach?
  - Did the breach have an impact on any of the applications or tools used for financial reporting and consequently on the internal financial controls over financial reporting
  - Impact on privileged accesses
  - What are the mitigating IT controls
  - In the absence of mitigating IT controls, are there adequate mitigating manual controls to address the risk

# Internal controls

## Walkthroughs and design considerations

# Internal Control Considerations

## Virtual walkthrough considerations

The following are some of the considerations while performing virtual walkthroughs:

**How did the auditor obtain the relevant information?**

Information may need to be obtained in new ways when conducting a virtual walkthrough. Consider the following:

- Transfer any information using secured platforms / share point
- Has all the relevant information been viewed or clearly visible
- Request for all the relevant information including screen shots through a secured platform and validate the same with the notes made during walkthrough
- Reach out to the process owners from the entity, to confirm the understanding of the process and information that was provided

# COVID-19: Internal Control — Design Considerations

The following are some of the changes that could probably impact the design of the control:

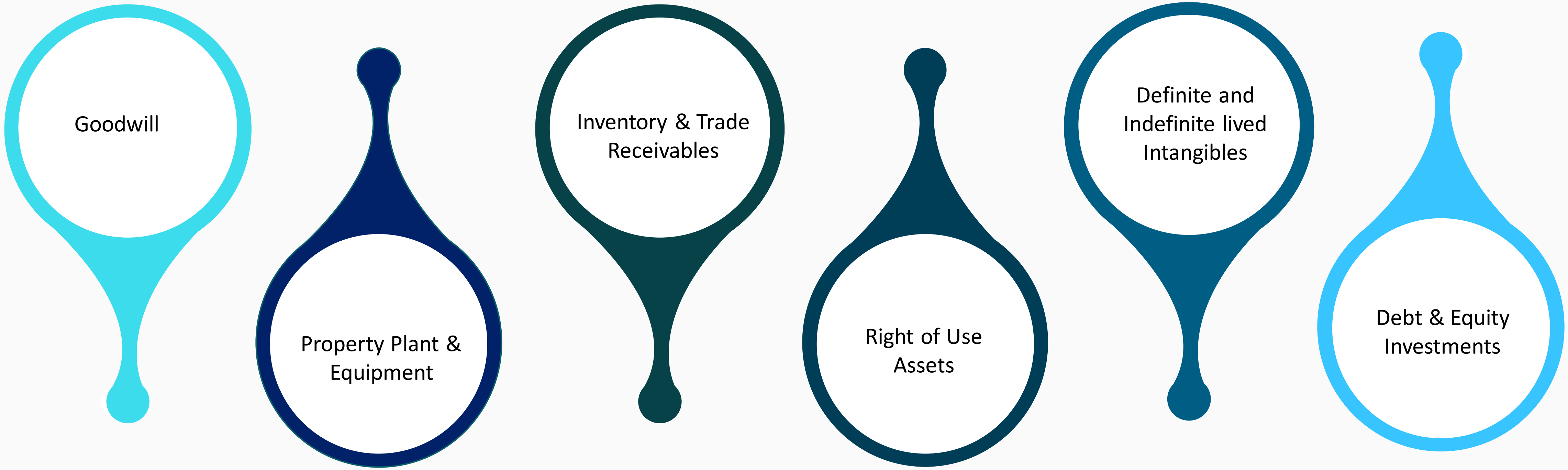
- Changes to manual controls that are designed to be performed in person or physically
- Changes to controls that are performed through meetings
- Controls with a review element – how is the review performed
- Changes to controls that require physical observations like physical verification of inventory, cash, PP&E
- Documentation of the revised controls and its monitoring

# Auditing accounting estimates

# Assessing Financial Impact and their Reasonable Estimation (SA 540, Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures)

**Objectives of the auditor:**

The objective of the auditor is to obtain sufficient appropriate audit evidence whether in the context of the applicable financial reporting framework: (a) accounting estimates, including fair value accounting estimates, in the financial statements, whether recognised or disclosed, are reasonable; and (b) related disclosures in the financial statements are adequate



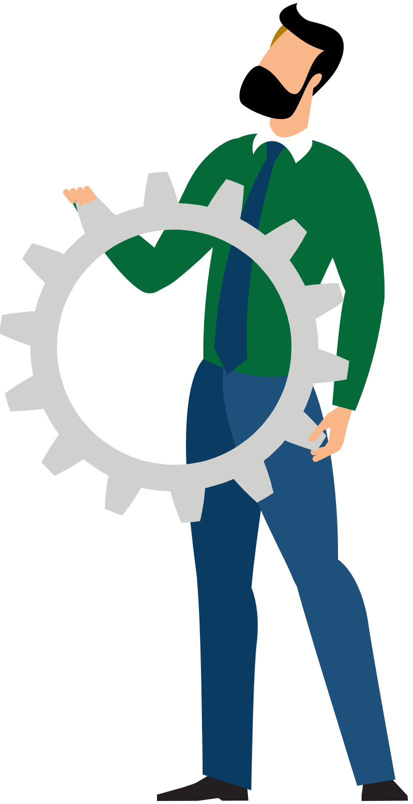
# Assessing Financial Impact and their Reasonable Estimation (SA 540, Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures)

**Some considerations while auditing business and valuation assumptions:**

| SIGNIFICANT DATA POINTS | CONSIDERATIONS DURING VALUATION |
|---|---|
| **Dependency of the business on macro economic factors** | Consider whether the business is (i) not impacted by COVID-19 (ii) Business impact (long term) – for example an e-commerce company or food delivery companies who have benefitted from the pandemic (iii) Business impact (short term) – for certain industries where the growth may have been impacted in the short term but are expected to return to pre-COVID times shortly (iv) badly impacted by the pandemic such as travel, tourism, entertainment |
| **Events between valuation date and report date** | • Very important to consider the subsequent events until report date and their impact on the valuation and business assumptions<br>• Use of professional judgement to consider any such circumstances / events which are relevant for valuation |
| **Some points to consider at the starting point** | (i) Business Plan<br>(ii) Customers and Suppliers (including impact of force majeure clauses)<br>(iii) Products and Service (availability, process)<br>(iv) Operations<br>(v) Liquidity<br>(vi) Profitability<br>(vii) Customer Behaviour<br>(viii) Going Concern Assumptions (watch for contradictory evidence) |

# Assessing Financial Impact and their Reasonable Estimation (SA 540, Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures)

| Income Approach – Some Considerations | Market Approach – Some Considerations |
|---|---|
| • **Cash Flow Projections** : Normalising adjustments to revenue and expenditure as part of the forecasting models<br>• **Cash Flow Considerations** : Such as Revenue and profit levels, working capital requirements, Expansion plans, Borrowings. Different scenarios – Business usual scenario Vs A short / medium term disruption scenario<br>• **Long Term Growth Rate** : Consider sector outlook, company specific factors and COVID-19 impact. Overall drop in risk-free rates and long-term economy wide nominal growth expectation to be factored in<br>• **Discount Rate** : Must be based on what is “known or knowable” as on the valuation date. Adjusted for COVID if the valuer is unable to make realistic adjustments to cash flows. | • Sufficient access to market data on sufficiently comparable competitors is a pre-requisite<br>• There is a risk of using pre-COVID transactions in post-COVID valuations<br>• Evaluate maintainable revenue and earnings from a market participants’ perspective<br>• Assess whether recent transactions are still comparable<br>• Assess whether the current market price reflect the long-term fair value |



**WATCH FOR CONTRADICTORY AUDIT EVIDENCE**

# Impact of climate on cash flow projections (impairment of non-financial assets)

| Assumptions | How does climate impact these assumptions |
|---|---|
| **Projected future cash flows** | The revenue or the capital expenditure to be incurred by an entity could be affected by climate related risks and opportunities. Therefore it is very important to understand the impact while testing these assumptions.<br>• Revenue and customer behaviours patterns<br>• Government policies and regulations may affect Companies in specific industries (for example : plastic)<br>• A company with high exposure to climate related risks may have an impact on their growth rates on account of high cost of capital / borrowings with investors and lenders factoring in climate related risks while making investment / lending decisions<br>• Physical climatic conditions like temperature, weather conditions, non-availability of adequate water may affect agricultural yields<br>• Emerging green technologies or change in the production lines to address climate related risks will result in companies incurring higher capital expenditure<br>The management will also have to consider the impact of climate related risks in the terminal growth |
| **Impact on other assets such as PP&E** | Where circumstances exists that indicate that a particular item of property plant & equipment may no longer be available or commercially viable for use, these factors should be considered while reviewing the useful life of assets |

# Going concern assumptions

# Going concern considerations (SA 570(R) Going concern)

Factors to be considered by management when assessing the going concern assumption

Management to consider (i) Regulatory considerations (ii) Operating environment considerations (iii) Liquidity considerations
(iv) Management's information and forecasting capability considerations

Auditor's Responsibility

- Assess how management addressed each of the considerations
- Focus on the most sensitive assumptions
- Maintain appropriate level of skepticism
- Consider the necessity to involve an expert

What is the period to be considered for the going concern assessment

Ind AS 1 and AS 1 require that all available information about the future, which is at least, but not limited to, twelve months from the end of the reporting period, should be considered by management.

Auditor's Responsibility

- If management's assessment covers less than 12 months, request the management to extend its assessment period to at least 12 months
- Remain alert for known or expected events that will occur after 12 months
- Perform additional procedures to assess the impact of the pandemic

Probable changes to the assessment compared to earlier periods

- The assumptions should be regularly updated by the management for the effects of COVID-19
- Shift from reliance on historic data and known changes to business and industry as they may not provide an appropriate basis
- Prepare a range of scenarios based on various dates of recovery
- Use sources such as industry reports, analyst reports, third party studies, data from WHO or government sources

Auditor's Responsibility

- Ask management to challenge their assumptions
- Discuss with the management on their future plans and understand how the estimates have been developed
- Test internal controls around developing the estimates (as applicable)
- Evaluate the reliability of the underlying data
- Determine if all assumptions are adequately supported
- Review the sensitivity analysis performed

# Going concern considerations (SA 570(R) Going concern)

- Cash flow Projections
- Client operating in any of the Covid effected industries
- Supply chain disruptions
- Customers who have shut down or adversely impacted by the pandemic
- Operational disruption
- Increased credit risk (for example on receivables)
- Ability to repay the dues / borrowings
- Effect of force-majeure clauses
- Legal and contractual implications
- Liquidity and working capital
- Access to capital
- Breach of loan covenants, trigger of cross default clauses
- Downward asset valuations
- Where support letter has been provided from the holding/ group company

**Conclusion**

When events or conditions have been identified that, when considered in the aggregate, indicate that there could be significant doubt about an entity's ability to continue as a going concern, ensure (1) appropriateness of the planned audit procedures, (2) adequacy of the entity's disclosures, and (3) implications for the auditor's report.

# Some specific key areas

# Physical verification of inventory (SA 501 Audit Evidence – Specific considerations for selected items)

| Inventory verification not conducted by management | Inventory verification conducted by management on a date other than the date of FS | Impracticable to attend PV – Alternate procedures | Inventory held by third party | Inventory in transit / Cut off procedure |
|---|---|---|---|---|
| • Understand the reason for not performing the physical verification<br>• Reassess the risk of material misstatement<br>• Perform test of controls and other substantive procedures (for example : validation of purchases, subsequent sales for all items)<br>• Refer to para 7 of SA 501 for circumstances where the inventory counting is impracticable | • Perform roll forward / roll back procedures as applicable<br>• Understand if above approach may be appropriate in case where the industry of the entity has been adversely affected<br>• Understand if there is a perpetual inventory system and test controls and perform substantive procedures | • Using the work of internal auditor<br>• Engaging other chartered accountant(s) to attend physical verification<br>• Use of technology in inventory counting | • Obtain direct confirmation on the existence and the condition of the inventory with third parties<br>• Read and understand the contract with the third party to understand his roles and responsibilities | • Understand from the management as to inventories that are locked in transit and test for contracts and other evidences regarding purchase / sales<br>• Cut off procedures : inform the entity to share the last documents (as applicable) for cut off even if auditor is not able to physically visit<br>• When doing the audit, see evidences to test last transactions and trace its actual movement with supporting documents |

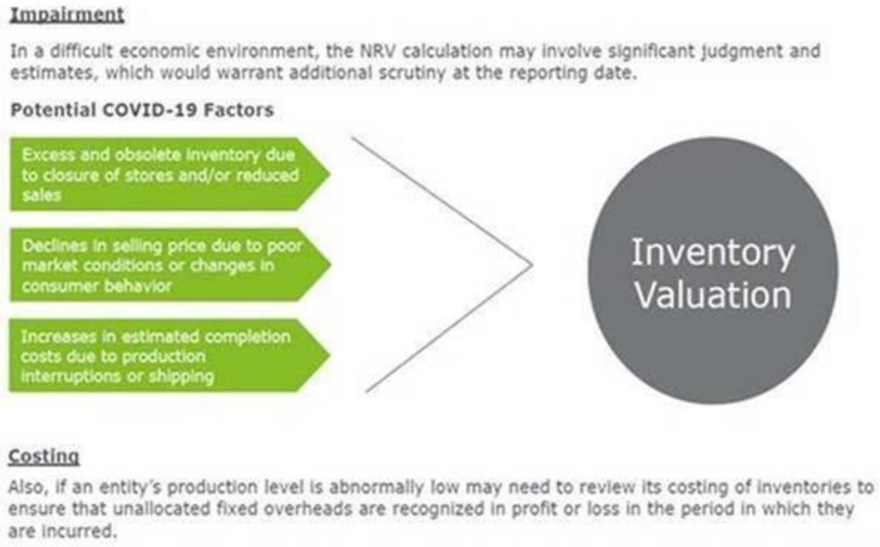
# Inventory Valuation

Inventories are highly susceptible to fraud, including misappropriation, hence, it is essential that auditors increase professional scepticism

It is very important to understand the impact on inventory valuation and the net realisable value. For example : is there is a market for the inventory, have the inventory process come down, has the entity been able to produce its normal capacity or has there been a significant reduction in production of goods

**Some signals to watch for (the more "yes" higher the risk)***

- Is the company attempting to obtain financing secured by inventory?
- Is inventory a significant balance sheet item?
- Has the percentage of inventory to total assets increased over time?
- Has the ratio of cost of sales to total sales decreased over time?
- Have shipping costs fallen compared with total inventory?
- Has inventory turnover slowed over time?
- Have there been significant adjusting entries that have increased the inventory balance?
- After the close of an accounting period, have material reversing entries been made to the inventory account?
- Does the company have a complex system to determine the value of inventory?
- Is the company involved in technology or another volatile or rapidly changing industry?




*Adapted from Journal of Accountancy publication of June 1, 2001 Ghost Goods: How to Spot Phantom Inventory

# Confirmations : Some points to ponder

Some tips in this regard:

- Validate the email address of the relevant sender (confirming party) – e.g., is this the same id that the Management otherwise uses in their correspondences / follow ups
- Check whether all elements of the confirmation request have been addressed by the confirming party
- Speak to the confirming party - consider calling the board / land line number of the organisation / entity
- Some questions that could be asked to the confirming party could include (i) understanding if he / she is the authorized representative of the confirming entity (ii) if he / she is the intended recipient of the request for confirmation (iii) if the person has responded to the request (iv) what was the balance that was confirmed (v) any other matters which has not been included as part of the response to the confirmation
- Document the call details, top up with sending a confirmatory mail listing the contents of the conversation
- Consider using the help of forensic specialists to check validity of domain name
- Look out for generic IDs [for example : vendorconfirmation@xyz.com, (where XYZ is the name of the confirming entity)]
- Beware of personal IDs [for example : gmail or yahoo]
- Look out for similar names or IDs for different vendors / suppliers (see if any of these coincide with those of an employee)
- Where not received, top up with reminders – try calling, possible that the other person did not exist in the first place
- Evaluate changes made to customer master, vendor master, employee master

Please note that these are illustrative procedures and do not cover the procedures that are required to be covered in all confirmation process (such as determining the information to be confirmed or requested, selecting the appropriate confirming party, designing the confirmation requests, etc.) for which auditors will have to comply with SA 505 – External Confirmations

# Subsequent Events

Auditors are required to perform procedures designed to obtain sufficient appropriate audit evidence that all events requiring adjustment of, or disclosure in, the financial statements, occurring between the date of the financial statements and the date of the auditor's report, have been identified and appropriately reflected in the financial statements in accordance with the applicable financial reporting framework (please refer paragraphs 6–8 of SA 560).

In undertaking work to be responsive to the auditor's risk assessment pertaining to subsequent events, including reasons related to the impact of the COVID-19 pandemic, the auditor considers management's adjustments or disclosures, including the timelines used to distinguish between adjusting and non-adjusting events. In addition, this includes the impact of the changes in the environment on the recognition and measurement of account balances and transactions in the financial statements (if adjusting), or other specific disclosures (if non-adjusting).

**Some examples of events and conditions that may be relevant under COVID-19 scenario:**

- New commitments, borrowings or guarantees that have been entered into as a result of the pandemic
- Invocation of force majeure clause after the year-end by any party
- Recent or planned sales or acquisitions of assets as a result of the pandemic
- Expected credit loss provisioning – where there are customers in COVID-19 impacted countries and where they have filed for liquidation post the entity's year-end will impact the collectability of the trade receivables
- Any developments regarding contingencies
- Any events that are relevant to the measurement of estimates or provisions made in the financial statements
- Modification of existing contractual arrangements
- Tax considerations
- Employee termination benefits resulting from a workforce reduction
- Impact on realizable values of inventory of a short-term nature in case of inability to sell the products during the period of lockdown
- Dishonour of payments / EMI received from debtors / borrowers
- Indications of impairment in the value of investments in companies whose businesses have been severely affected by the pandemic
- Any other significant events which would raise doubts over the entity's ability to continue as a going concern in accordance with SA 570(Revised), "Going Concern