May 2020

AUDIT 03/20

COMMUNICATION IN RELATION TO THE IMPACT OF COVID-19 ON AUDITING - DETAILED

Objective

This guidance is being made available by the Malta Institute of Accountants (MIA) to assist auditors in mitigating the implications of COVID-19 on the audit process. The COVID-19 virus was declared as a public health emergency of international concern by World Health Organisation (WHO) on 30th January 2020.

This guidance, which has been endorsed by the MIA Audit and Assurance Committee, is intended to be used by auditors for reference purposes when auditing financial statements during 2020 and does not contain an exhaustive presentation of all possible scenarios that might be encountered, as a result of the pandemic.

It is the responsibility of every auditor to exercise professional judgement accordingly. The MIA shall not be held responsible for any loss sustained by any person who relies on this guidance.

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1. Impact on audit risk assessment and further audit procedures

1.1 Possible implications on the auditor's risk assessment

As the current situation is very fluid, COVID-19's impact on an auditor's risk assessment of an entity will need to be constantly reconsidered during the audit. This must be done until the audit report signing date, in line with **ISA 315**. The auditor may have to consider the following aspects:

- For which types of business transactions, items, information and statements in the financial statements is the risk of material misstatement potentially increased in the entity to be audited? Examples might include intangible asset impairment; loss allowances for expected credit losses; inventory obsolescence; non-compliance with laws and regulations or contractual commitments; etc.
- Are there IT General Controls (ITGCs) threats which need to be considered or cyber risks relevant to the audit? For example, lack of control to detect phishing;
- Is there a potential higher fraud risk due to management being under new pressures?
- Which categories of information or, if applicable, individual disclosures or groups of disclosures are of fundamental importance for the understanding of the position of the entity as a whole and which types of statements are potentially affected? For example, the directors' report.
- Is it likely that the entity or group or significant parts of the group will not be able to generate certain accounting-related information in a timely manner or in the required quality, for example due to staff shortages?
- Have the client's accounting policies changed? An example could be a change in the exercise of discretion in recognising provisions.

In relation to the above aspects, it is also important to keep in mind whether the event is considered to be an adjusting or non-adjusting event (and therefore whether this impacts recognition or disclosure – For further guidance, refer to point '**3. Subsequent events**' below.

1.2 Implications on audit evidence

It is the auditor's responsibility to obtain sufficient and appropriate evidence before issuing the audit report. Due to the existing limitations including access and travel restrictions, as well as the limited availability of personnel due to health considerations, auditors are advised to explore alternative audit procedures in order to obtain the comfort required in line with the risks identified. This could include the use of video conferencing tools to validate signing and observation of documents. **ISA 500** provides further details and guidance in this regard.

In the following scenarios challenges may be encountered during the audit process:

- Reliance on internal controls: If the entity's personnel are working remotely, in many circumstances this may mean that the design and operation of internal controls may have changed or are no longer effective. Although the controls may have been operating during the year, the controls around the financial statement process after year end might have changed. Another example where an auditor may encounter difficulty could arise when the auditor has tested the controls during the first nine months of the year but is limited in carrying out update testing for the last three months of the audit period. Similar to risk assessment, these changes may occur at any stage during the audit period or during any phase of the audit. In these cases, the auditor may need to update the risk assessment and audit strategy and plan.

- Potential inability of clients to leverage the competencies of experts: This situation might arise for example in the case of real estate valuers, professional legal advisors etc., whose input may be paramount especially in areas of higher estimation uncertainty and inherent judgement. Early identification of any such restrictions and a viable audit time plan, would need to be determined.

- Physical inventory observations: If inventory is material to the financial statements, **ISA 501** requires auditors to obtain sufficient appropriate audit evidence regarding its existence and condition by attending the entity's physical inventory count, unless attendance is impracticable. If the auditor believes that it is impracticable, sufficient appropriate audit evidence about the existence and condition of the entity's inventory by means of alternative audit procedures, still needs to be obtained. Examples of alternative audit procedures include using counts already carried out during the year and carrying out roll-forward procedures; carrying out subsequent control counts and carrying out roll-back procedures; and providing evidence of the subsequent sale of certain inventories. The effectiveness of these alternative procedures will depend on a number of factors including client's controls over stock records, rate of inventory turnover, supporting documentation for the intervening period and other circumstance-specific factors. The following considerations should also be borne in mind:

  ◊ Observing an inventory count involves more than selecting and recording test counts to test the accuracy of the entity's records and processes for tracking quantities on hand (the "existence" assertion). The auditor also assesses the condition of the inventory (the "valuation" assertion), accuracy of the inventory description, cut-off procedures and controls, completeness of the inventory counted (for example tests of tag control or similar procedures) and other aspects of the entity's controls related to inventory counts. The auditor also tours the facility to understand the layout of the facility, the location of inventory and remains alert for any unexpected inventory movement during the inventory count. When evaluating whether alternative procedures will allow the auditor to obtain sufficient appropriate audit evidence, consideration needs to be made on whether all of the objectives of these various procedures can be achieved.

  ◊ In some cases, the auditor will not be able to obtain sufficient appropriate audit evidence through alternative procedures, in which case **ISA 501** requires modification of the audit opinion in accordance with **ISA 705 (Revised)**.

- An increased risk of material misstatement due to production or sales difficulties: If the valuation of stock (including WIP) for financial years ending after 31 December 2019 present an increased risk, further audit procedures should be carried out to focus in particular on the audit objective "valuation of products" by obtaining information about open orders and prices in tenders and/or publicly available market prices. Analytical procedures based on a purely historical analysis of, for example, inventory turnover or inventory coverage, may be less relevant in the current situation. In relation to this assertion, the auditor should bear in mind that the risk of stock obsolescence is higher given the current market environment and the fact that discounts may need to be given to sell current stocks.

- **Group audit engagements:**
  - ◊ With subsidiaries to which access to review working papers is restricted, the group auditors can discuss with clients to amend reporting timescales, if possible, and/or can undertake other measures to allow them to meet the requirements of **ISA 600**. The use of technology in these situations should be further exploited and the below options should be considered:
  - ◊ Can the component auditor be asked to complete a detailed questionnaire or include additional detail in the memorandum (prepared for group reporting purposes) on the work performed?
  - ◊ Can a more detailed memorandum be provided to the component auditor on what work should be done for group reporting?
  - ◊ Can group auditors be given access to the electronic audit file of component auditors to allow for review?
  - ◊ In the event of personnel restrictions on the part of component auditors, consideration should be given to having certain audit procedures performed by the group audit team, provided that the information required to generate audit evidence can be accessed centrally. It may be advisable to supplement the group audit instructions in this regard.

Due to the current conditions, audits may require additional time, which may impact reporting deadlines (refer to some of the latest reporting deadline extensions, as at guidance date in links: **CFR**, **MGA**, **MFSA** & **Prospects** - subject to updates by the relevant authority in the coming days). If extension is not possible, auditors may need to modify their audit report to reflect that they have not been able to obtain the necessary audit evidence. For further guidance, refer to point '**6. Impact on Auditor's Report**' below.

2. Communication with those charged with governance (TCWG)

Auditors are reminded that it is important that they communicate timely and appropriately with the entity's management and TCWG, including the Audit Committee, about the impact of the COVID-19 outbreak on their audit work, whilst always keeping in mind scepticism and independence. In general, auditors are advised to be proactive and discuss with their clients the impact of the COVID-19 on the entity, its business, operations, reporting schedule and the related audit plan, including their respective contingency plans.

It is paramount that the auditor obtains the client's assessment on the impacts of COVID-19 and that the auditor does not seek to carry out this assessment himself or herself. The auditor should consider asking the client questions when seeking to obtain and understand the client's assessment. An illustrative of such questions can be found as per **Appendix A - Communication with TCWG.**

3. Subsequent events

Where management determines that the COVID-19 outbreak is a non-adjusting subsequent event for an entity's most recently ended financial year, management should however consider the implications of COVID-19 on the disclosures in the financial statements of the entity's current reporting period.

Information should be given on the post-closing impact of COVID-19 so that users of the financial statements are properly informed. It should include the nature of the event, as well as an estimate of the impact on the financial statements when possible. The auditor should exercise professional scepticism while assessing whether the disclosure note is clear and specific enough. In line with **ISA 560**, the subsequent events assessment is required until sign off date and in the current circumstances this requirement is even more imperative given the fluidity of the situation and the changing factors and circumstances that may need to be taken into account in the disclosure.

For 31 December 2019 financial statements, the financial reporting effects of the COVID-19 outbreak are generally appropriate to consider as non-adjusting events, because the significant changes in business activities and economic conditions occurred as a result of events arising after this reporting date. Many actions taken by governments and the private sector to respond to the outbreak followed after 31 December 2019. As one can observe (by referring to stocks such as FTSE 100 and Dow Jones Industrial Average as per **reuters.com**) the effects of the COVID-19 outbreak did not have a significant impact on global markets and share prices until after 31 January 2020. For later financial year ends, more judgment will be required to consider whether the full effects of COVID-19 were apparent at the entity's period end.

Please note that as per IAS 10, if the going concern assumption is no longer appropriate, a fundamental change in the basis of accounting would be required rather than an adjustment to the amounts reported within the original basis of accounting.

4. Assessment of Going Concern

Auditors should pay close attention to the entity's assessment regarding its ability to continue as a going concern as the uncertainty around the forecasts for economies worldwide and the increased uncertainty around the position for many entities may pose a challenge to the auditors' assessment.

The going concern assumption may not be used if management intends to liquidate the entity or if the capacity of the entity to continue as a going concern is compromised because of COVID-19 impacts.

When performing the assessment, the auditor should keep in mind the industry the entity is operating in; whether the entity continued operating or not in this situation; and the level of commitments it has. The going concern risk and hence the scaling up or down of procedures, will vary accordingly. The effects of COVID-19 on an entity could include the following:

- Significant reduction in cash inflows and increase in bad debt losses, hence reducing the entity's ability to meet its ongoing obligations;
- Limited access to external sources of financing to meet short-term financing needs due to restrictive lending by banks and/or unfavourable market conditions for the issuance of equity instruments;
- The breach of covenant clauses in loan agreements, which would trigger an obligation to repay substantial loan amounts prematurely. The same may be the case if deadlines within which financial information is to be made available to lenders, are exceeded. Possible contractual and/or legal success in obtaining a right to refuse performance may reduce the doubts raised about the ability to continue as a going concern. Similar concerns may be encountered for regulated companies if they are unable to meet regulatory capital requirements;
- Temporarily stoppage of production activities due to staff or supply shortages of suppliers or as a result of the collapse of the main sales markets;
- An overindebted balance sheet due to lower selling prices of inventories and high stock levels, impromptu depreciation of property, plant and equipment or intangible assets, bad debts or impairment of financial assets.

ISA 570 remains applicable and with reference to the above examples, management's assessment of going concern may need to include:

- updating forecasts and sensitiveness as appropriate consideration will need to be given to the risk factors identified, reliability of accounting estimates on generation of future income and different possible outcomes;
- reviewing of projected covenant compliance in different scenarios;
- changing management's plans for future actions;
- cash flow impacts; and
- expanding disclosures.

When assessing the assumption of the continuation of the entity's operations, the forecasts required for the valuation of asset and liability items should be taken into account. Consideration should be given to those measures that have not yet been implemented (by the date of signing of the audit report) and the uncertainties around their implementation.

The consideration of such measures should be explained in the notes or directors' report and should reflect the following:

◊ Are the assumptions up-to-date, for example in relation to the general restrictions on travel and movement that may be relevant for forecasting sales development?

◊ Are the conditions for the eligibility of any Government aid included in the liquidity forecast fulfilled?

◊ Do the legal representatives act accordingly (for example actual application for Government aid)?

When performing group audits, the going concern assumption for a subsidiary may be closely linked with the assessment of the going concern basis for the group as a whole, as the component auditor may need support from the group engagement team in order to obtain audit evidence for the assessment. Hence, as things are changing, going concern assessment may need to be performed more than once and a moving signing date becomes more critical to address in these situations.

5. Representations

The auditor should also consider additional matters to be included in the letter of representation (LOR) including, amongst others, the following:

- Documenting the conclusions made by management upon studying and analysing the impact of COVID-19 and considering all possible scenarios, such as whether:
  - ◊ they consider the event adjusting or non-adjusting;
  - ◊ the estimated impact (or that it is not possible to estimate); and
  - ◊ their assessment as to how this specific event impacts their assessment of going concern.
- Confirmation that the information provided is complete and true and where copies of documentation were provided, they were true copies of the originals. This is important in a context where the auditor is receiving a lot of scanned information.

6. Impact on Auditor's Report

Potential effects on the auditor's report may include:

- For public interest entities, a Key Audit Matter (KAM) related to additional audit work may be considered because of the COVID-19 outbreak, for example, to describe the approach for group audit;
- An 'emphasis of matter' paragraph, for example, to highlight a significant subsequent event disclosed in the financial statements, a significant uncertainty arising from the outbreak or disclosures that are considered fundamental to users' understanding of the financial statements;
- A material uncertainty in relation to a going concern paragraph;
- A qualification, or adverse opinion, for example, in respect of inadequate disclosures, or going concern uncertainties, in the financial statements;
- A qualified opinion, or a disclaimer of opinion, because of scope limitation when unable to obtain sufficient appropriate audit evidence, for example,:
  - ◊ When stocktakes could not be attended in person;
  - ◊ If the information required in the notes on events after the balance sheet date, in the opinion of the auditor, were omitted and this is a material misstatement

of the financial statements;

◊ If the information required for the preparation and audit of the consolidated financial statements could not be obtained in a timely manner from the subsidiaries (or business segments) located in the regions concerned and, as a result, inclusion was based on (statistically extrapolated, if applicable) prior-year figures;

◊ If the statutory auditor was unable to obtain sufficient appropriate audit evidence about the financial information of the audited entity or the financial information of any of the subsidiaries. Depending on the scope of the possible effects on the consolidated financial statements, this may possibly result in a qualified audit opinion or even a disclaimer of opinion.

Auditors need to also consider their responsibilities in relation to other information presented by the directors within the annual report. This is covered in **ISA 720** .

When the entity has been materially affected and auditors have concluded that the accounting is not appropriate and/or that the financial statement disclosures made by management are inadequate or inappropriate, **ISA 705 (Revised)** requires auditors to issue a qualified or adverse opinion, as appropriate in the circumstances. The opinion issued depends on the materiality and pervasiveness of the impact on the financial statements.

7. Delivery of reporting

The completion of the audit requires the signing of the audit report and its presentation to the regulator. It is recommended that the logistics around the actual signing of reports and potential work arounds are discussed with clients and regulators accordingly. The auditor should be aware of regulators' statements in this regard. Below are examples of recently issued communications on the subject matter:

- The Malta Financial Services Authority (MFSA) on 14th April, 2020 issued a **circular** stating that audited financial statements, can be submitted with an email by the Chairman of the Board. Original signed documents, certified true copies and any other documentation that is ordinarily submitted to the Authority in physical format will be expected to be submitted retrospectively at a future date, as and when communicated by the MFSA.
- On 25th March, 2020 the Malta Business Registry (MBR) **noted** that every entity is required to submit to the Registrar an Annual Return accompanied by the appropriate registration fee by not later than 42 days from the anniversary date of the entity and the financial statements by not later than ten months and 42 days (private entity) or seven months and 42 days (public entity) from the financial year end. These can also be submitted in paper format and may be left in an envelope and delivered in a dedicated letterbox at the entrance of their premises. Processing of documents, left at the letterbox, will start after five days from delivery to minimise any health risks for MBR's employees. The Registrar further announced that if an entity is effected by

the COVID-19 situation and the filing of the annual return and/or financial statements falls within the period of 23rd March 2020 and 31st May 2020, the relevant penalties on late filings of annual return and financial statements will not be imposed if these are filed with the Registrar by 31st July 2020.

Further to the above examples, reference needs to be made to the respective regulators' website for updated information on the subject matter.

Appendix A - Communication with TCWG

1. How has COVID-19 impacted or expected to impact your financial position and results of operations?
2. How has COVID-19 impacted your capital and financial resources, including your overall liquidity position and outlook?
3. How do you expect COVID-19 to affect the assets on your balance sheet and your ability to timely account for those assets? For example, will there be significant changes in judgments in determining the fair-value of assets measured in accordance with GAPSME or IFRS?
4. 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?
5. Have COVID-19-related circumstances such as remote work arrangements adversely affected your ability to maintain operations, including financial reporting systems, internal control over financial reporting and disclosure controls and procedures?
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?
11. Are you considering COVID-19 as an adjusting or non-adjusting event?

The above list of questions is illustrative but not exhaustive and each entity will need to carefully assess COVID-19's impact and related material disclosure obligations.

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