COVID-19: Challenges to auditing

KPMG Board Leadership Centre

In a joint statement, the Financial Conduct Authority (FCA), the Financial Reporting Council (FRC) and the Prudential Regulation Authority (PRA), identify a series of actions, designed to protect the capital markets by ensuring the continued flow of information to investors.

Here we summarise, from a company perspective, the guidance for auditors facing challenges to the traditional ways in which they gather audit evidence.

Highlights from the joint statement[1]

While unprecedented, the impacts of the COVID-19 pandemic are likely to rebound sharply once social restrictions are lifted. In the meantime maintaining the communication of accurate and timely information to investors is vital.

Users of financial statements are encouraged to take into account the unique set of circumstances arising which might result in uncertainty, delays and an increase in modified audit opinions.

In particular, given the common goal that the financial system should be a source of strength for the real economy, lenders are encouraged to take account of these circumstances when responding to covenant breaches.

> "*The package of measures today is designed to give [companies and their auditors] the ability to consider the impact of Covid-19 more comprehensively in the light of government and other responses and provide markets and investors with the information they need to make informed decisions.*"
>
> David Rule
> Executive Director of Supervision at the FRC

Guidance for auditors

The FRC have provided guidance to assist auditors in a handful of potential problem areas. The guidance will be updated as new matters are identified and should only be considered as short term solutions where previously well established processes are not possible in the current circumstances.

The guidance is designed to assist auditors in overcoming issues but will none the less lead to an increase in the work required and most likely the time taken to perform the work when compared to a traditional audit.

Review of incumbent working papers when taking over a new engagement

Auditors are advised to leverage technology to enable remote working as much as possible. Any matters requiring physical presence should be flagged for follow up, before the end of the audit.

Questions may therefore be raised with management much later in the year than typically anticipated.

Changes to the planned audit approach

Auditors are reminded that they may need to revisit their risk assessment in light of the pandemic. This could impact their determination of which areas are to be tested as well as the volume of testing to be performed.

As controls may be being performed differently than usual, the way in which they are to be tested may differ. This could in turn mean additional testing around mitigating and / or overarching controls.

Auditors are advised to consider whether the change in the control environment might impact their assessment of the risk of material misstatement due to fraud or irregularity. If your business has historically displayed very strong internal governance this will almost certainly be somewhat eroded by the current crisis and may drive an increase in the volume and nature of testing required to gain the comfort required to support an audit opinion.

[1] http://www.frc.org.uk/about-the-frc/covid-19/covid19-joint-statement-26th-march-2020

Changes to materiality

Materiality always needs to be reconsidered at the year end but good company forecasting typically means that little or no change is required. In light of significant performance impacts, both favourable and unfavourable, a higher level of changes to materiality is to be expected where the performance period includes the impact of the pandemic.

Further, auditors are advised to consider whether a separate level of materiality should be applied to any particular classes of transactions which are uniquely impacted.

Communicating with those charged with governance

Auditors are reminded that both the nature, frequency and the duration of communications are likely to require consideration. The restrictions associated with remote discussions will need to be carefully overcome and more time may be required than usual to achieve this. There will also likely to be more to discuss given the current crisis so an additional lengthy 'virtual' meeting is to be anticipated.

Also, we can expect to see a higher number of modified opinions. Auditors are reminded that they may discuss with you the option of delaying reporting to give the them time to complete additional work to obtain the evidence required to avoid the modification.

Audit evidence

Auditors are required to assess the sufficiency and appropriateness of audit evidence obtained. Changes to timetables and ways of working should be expected to drive differences in this assessment and possibly a change to the nature and volume of evidence required.

The physical verification of some items such as documents and inventories is a fundamental audit requirement. Auditors are advised that verification through another means might be suitable for less material balances. Innovative solutions for material items will need to be managed on a case by case basis.

Compliance with laws and regulations

Auditors of Public Interest Entities (PIEs) are reminded of their obligation to report to the FRC any information that they are made aware of which indicates: a breach of laws or provisions; a material threat to the functioning of the PIE; or an adverse or qualified opinion.

They are asked to report on 'material uncertainties' in the same way.

Going concern

Auditors are cautioned to remember, when auditing the going concern assessment, that we face an unprecedented level of uncertainly and so meaningful forecasting over the coming 12 months and even in the short term will be difficult to achieve.

They are reminded that if, given the current uncertainty and volatility, they need to report on material uncertainties, this should draw on the specific facts and circumstances available, and that they should not generically report on material uncertainties.

It is noted that given the current circumstances, audit work required over the going concern assessment is likely to be more extensive and they are encouraged to consider the requirements of the revised ISA even where it is not yet effective.

Businesses and those charged with governance should therefore expect a higher degree of attention on this area, in particular if they have identified no material impact from the current circumstances or that no material uncertainties related to going concern exist for the entity.

Restrictions to group audits

The FRC flag two potential disruptions to group audits. The first is that sufficient evidence for a certain component cannot be obtained by the local auditor because of restrictions in that location.

The second, and possibly more common, issue is where the local audit can go ahead but, due to travel restrictions, the group auditor is unable to perform the required review of the component work. In this case, the FRC confirm that 'there is no reason why a thoroughly executed and clearly documented electronic and video review of component auditors' work cannot satisfy the requirement in the standard'.

Reporting on Key audit matters

Where COVID-19 is determined to require disclosure as a key audit matter, auditors are reminded of the need to be specific in the way in which they report and avoid any boiler plate language.

Modified opinions

The FRC raise the possibility that there may be an increase in modifications as a result of the crisis.

Auditors are reminded that in such cases they should engage with those charged with governance to explore innovative alternatives such as additional or amended procedures, and reporting extensions.

Subsequent events

While for most UK based December year ends COVID-19 was not an adjusting post balance sheet event, the same will likely not be the case for later reporting dates where significant adjustment and disclosure may be required.

Support for audited entities

The FRC reminds auditors that non-audit services may be provided to PIEs where they are: addressing a time critical and price sensitive issue; and do not undermine the auditor's independence. They clarified that this includes 'supporting companies in making applications to any of the business support schemes announced by government in response to Covid-19'.

Please read our paper COVID-19: Corporate governance and reporting for further guidance from the FRC, FCA and PRA on the actions companies can take to help protect the capital markets and the flow of information to investors.

And, our paper COVID 19: Reporting timetable for listed companies includes further guidance from the FRC, FCA and PRA covering delays to the reporting timetable and other relaxations to ease the pressure on companies

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