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COVID-19 AND AUDIT REPORT IMPLICATIONS

We are currently working in extraordinary times; businesses and individuals are facing unprecedented and far reaching restrictions as a result of the response to the global pandemic. One of the key issues being faced by auditors is how to address the impact the Coronavirus outbreak has had on their work when issuing their report on the financial statements.

One of the biggest challenges faced by auditors when reporting will be how to address going concern issues faced by their client. Given the importance of this issue this has been considered in a separate article within this package. This article focuses on other audit reporting issues raised by the Coronavirus outbreak.

The Financial Reporting Council (FRC) has published guidance for auditors on drafting audit reports in the current climate which can be found here. This includes a diagram showing the possible options for the audit report which is reproduced as an appendix at the end of this article. The FRC COVID-19 Bulletin March 2020 also includes guidance intended to help auditors deal with the emerging situation and covers elements of auditor reporting.

In addition, the ICAEW have published guidance on 'Coronavirus: understanding audit reports', which can be found **here**.

Modified audit opinions

Inevitably there are going to be occasions when the auditor is going to need to consider modifying their opinion on the financial statements. This could arise in one of two ways:

1. The auditor is unable to obtain all the evidence they consider necessary to be able to conclude that the financial statements show a true and fair view. This limitation of scope will need to be reflected in the audit report by the issue of a qualified opinion. Alternatively If the limitation is considered to be pervasive in nature this would require the auditor to disclaim their opinion entirely.
2. The auditor has obtained all of the evidence they require, but the audit has revealed that the financial statements contain material misstatements that management are unwilling to correct. In such situations the auditor will need to issue a qualified opinion, unless the effect of misstatements is considered pervasive in which case an adverse opinion should be issued.

When considering whether an issue is pervasive or not, ISA (UK) 705 Modifications to the Opinion in the Independent Auditor's Report defines the term as meaning one that is either not confined to specific elements, accounts or items of the financial statements, or one that if it is confined to a single item represents, or could represent, a substantial proportion of the financial statements. Additionally a disclosure item is considered pervasive if it is fundamental to users' understanding of the financial statements.

The impact on the audit report can be shown by looking at a couple of examples:

Example 1

Company A is a manufacturing business with a 31 March year-end. Stock comprises a highly material component of the financial statements, but due to control measures in place the auditor was unable to inspect the stock held at 31 March 2020, and alternative procedures designed to verify the quantity of stock held at the year-end were not possible.

In this example the auditor does not disagree with the amount of stock reflected in the financial statements, but the scope of the audit has been limited due to the inability of the auditor to obtain sufficient, appropriate audit evidence to confirm the existence of stock. The amount of stock held is highly material and has an impact on both the company's balance sheet and its results for the year presented in the profit and loss account. As the impact is not confined to a single area of the financial statements this limitation of scope could be considered to be pervasive. If the auditor considers that this is pervasive then they will issue their report on the 2020 financial statements with a disclaimer of opinion.

In similar situations but where the level of stock held is not as highly material a qualified opinion rather than a complete disclaimer of opinion may be more appropriate.

Note that as the level of opening stock held will have a material impact on the company's results for the year ended 31 March 2021, consideration will also need to be given to modifying the auditor's opinion on the 2021 financial statements.

Example 2

Company B is a charity with a significant proportion of its assets held in listed investments. The charity's accounts for the year ended 31 December 2019 includes brief disclosure on post balance sheet events linked to the impact the pandemic has had on the charity but does not refer specifically to investments. This is despite the fact that at the date of the trustees' approval of the 2019 accounts in April 2020 the value of the charity's investment portfolio has fallen by more than a quarter.

The financial statements do not include a key disclosure, as the financial impact of non-adjusting balance sheet events should be given. The auditor does not consider this omission to be fundamental to users' understanding of the financial statements. In the unlikely situation that the trustees are unwilling to correct the financial statements the auditor will qualify their opinion for this material misstatement, referring to the missing disclosure in their report.

Unfortunately the FRC in their Compendium of Illustrated Auditors Reports do not provide examples of what an audit report containing a modified opinion should look like. Guidance on how audit reports should be amended to reflect a modified opinion has been issued by the ICAEW to its members though and should be referred to whenever drafting an audit report that departs from the FRC's standard audit report format. This can be found here.

In practice the situation may be complex with more than one issue needing to be reflected in the final audit report. In such circumstances we would encourage practitioners to consult with another experienced auditor to ensure that the report has been correctly drafted. Indeed, many audit methodologies require a second partner review to be undertaken whenever a modified audit report is being considered to help ensure that it has been correctly drafted. If the audit firm does not have the resource to do so internally then Mercia can help through use of our Technical Query facility which can be found here.

Emphasis of matter paragraphs

There may be matters included within the financial statements that the auditor wishes to highlight in their report but without the need to issue a modified opinion. Such matters will need to have been appropriately disclosed in line with the adopted reporting framework, but their importance to having a complete understanding of the entity's financial performance is such that is considered appropriate to highlight the issue in the audit report and bring it to the attention of the users of the accounts.

One issue that auditors may wish to refer to is a material uncertainty in the fair value of an asset or liability reflected in the entity's balance sheet. RICS has, for example, recently issued guidance to its members in respect of property valuations and the possible need to refer to the material uncertainty that may exist in those valuations at the present time. Provided that this is adequately disclosed in the accounts this may not result in any need to qualify the audit opinion, but this could be an issue that the auditor considers should be referred to in their report where it is fundamental to users' understanding of the financial statements.

This can be achieved through the use of an 'Emphasis of Matter' paragraph, which are addressed by ISA (UK) 706 Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report. The Standard suggests that such a paragraph would be included immediately after the 'Basis of Opinion' paragraph. The narrative of this paragraph should refer only to information that has been disclosed in the financial statements and make clear that the auditor's opinion has not been modified in respect of the matter.

Material uncertainties related to going concern

In relation to going concern, the format of the audit report will depend upon the following:

- Whether the financial statements have been prepared on the going concern basis or not.
- The auditor's conclusions on:
  - Whether sufficient appropriate audit evidence has been obtained to support the appropriateness of the going concern basis of accounting;
  - Whether one or more material uncertainties exits that cast significant doubt on the entity's ability to continue as a going concern; and
  - Whether sufficient disclosure has been included in the financial statements in respect of going concern issues or not.

The FRC has been clear that auditors should not just generically report on material uncertainties or include a statement as a matter of course. The audit report should reflect the circumstances of each engagement and where adequate disclosure is made on material uncertainties that exist and sufficient appropriate evidence has been obtained on the basis of preparation a material uncertainty related to going concern paragraph is included.

Scoping

Some auditors may consider it beneficial to refer to the exceptional circumstances under which the audit was performed as part of their report. In most situations the users of the financial statements should already be fully aware of the situation faced by auditors at the current time and additional wording is unlikely to be required. This is particularly true if it has already been necessary to refer to the pandemic in the audit report in connection with going concern issues or in connection with a limitation of scope.

In some limited circumstances though it may be useful to the users of the financial statements to highlight some of the challenges the pandemic presents for the auditor and the impact this has had on their audit approach. The inherent uncertainty that currently exists regarding the future economic environment and the implications for the assessment of going concern and the determination of accounting estimates are examples of issues that could be referred to.

If such wording is being considered then it may be presented immediately after the 'Basis for opinion' section of the audit report with a suitable heading such as 'The impact of Covid-19 and related macro-economic uncertainties on our audit'. The narrative that follows should relate to the specific circumstances of that audit engagement, with the FRC recently cautioning against the use of standard boilerplate text when including a scoping paragraph as part of the audit report.

Public Interest Entities (PIEs)

The audit reports that accompany the financial statements of PIEs and other entities that are required to report on how they have applied the UK Corporate Governance Code, or have chosen to do so voluntarily, are required to communicate information on key audit matters (KAMs). Often the impact of COVID-19 on the entity will be one of the most significant issues affecting the audit approach, in which case consideration should be given to reporting this as a KAMr.

As with any other KAM included within the report it is important to ensure that the wording used is specifically tailored to reflect the circumstances of the engagement and the challenges that have been faced and how they were resolved with particular focus on conclusions surround significant judgements.

When doing so this may remove the need for the auditor to use an Emphasis of Matter paragraph or an extended scoping paragraph to highlight an issue that is fundamental to understanding the financial statements.

Keeping your client informed

Whenever the auditor is considering the need to issue a modified audit report it is vital that they keep their client informed. Delivering a surprise at the completion of the audit process is unlikely to be welcomed by the client's management / those charged with governance (TCWG), and will damage the relationship between the auditor and their client. Not only that, it is possible that any qualification of the auditor's opinion could have been avoided if the possibility of one being issued is discussed at an earlier stage.

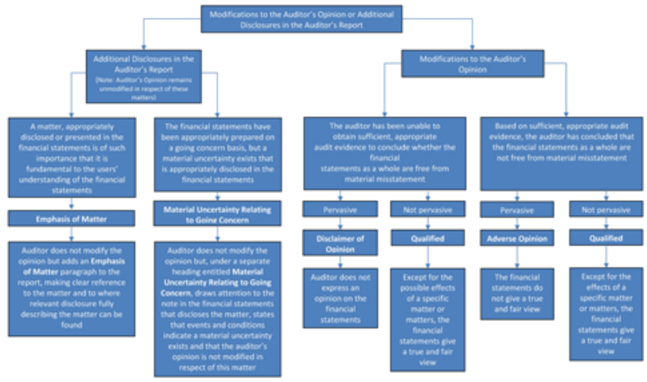
When faced with the possibility of a qualified opinion being issued due to a misstatement in the financial statements it is commonplace that through discussion of the issues involved management / TCWG will be willing to amend the financial statements so that the auditor can agree with their preparation.

Alternatively the discussion may help to better explain management's approach in preparing the financial statements, and help to demonstrate to the auditor that in fact they have been properly prepared and no misstatement exists. Clearly though the auditor must be confident that the accounts do indeed show a true and fair view before an unqualified opinion can be given.

Similarly early discussion of a potential limitation in the scope of the audit may enable the client to generate additional or better quality audit evidence that will enable the auditor to conclude that the accounts are free from material misstatement, and a qualified opinion avoided.

As is often the case good communication between the auditor and their client is key to ensuring that an appropriate audit report is issued.

Appendix: *Modifications to the Auditor's Opinion or Additional Disclosures in the Auditor's Report*



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