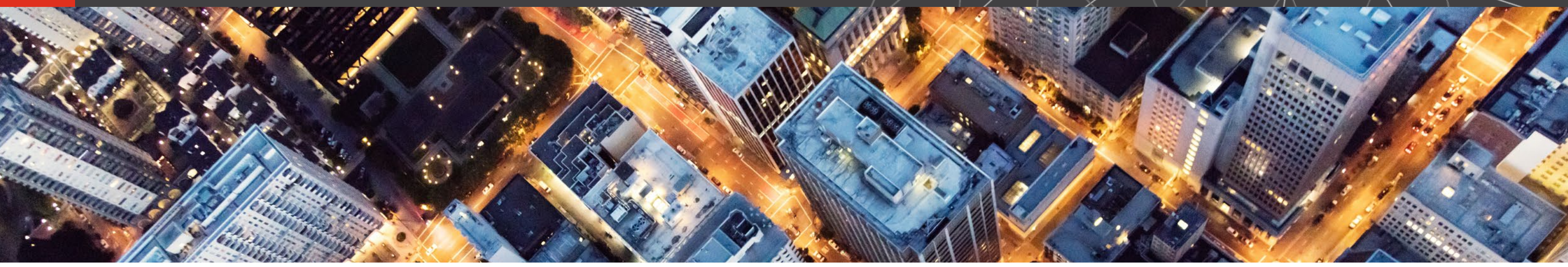
Likely impact of COVID-19 on audit reports

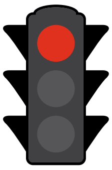


COVID-19 is affecting businesses in many ways, including their financial reporting, in particular for 31 March 2020 reporters.

These matters will also, in many cases, impact the audit reports on the 31 March 2020 financial statements (and potentially for subsequent reporting year ends). Directors have raised concerns with auditors about how banks and other stakeholders may interpret entities audit reports. Many entities have covenants that may not be fully met with an unqualified audit report. We are dealing with a unique set of circumstances. Some of these mean the auditor has no option but to qualify the audit report.

In this paper we outline some of the scenarios we expect to see in audit reports over the coming months. The analogy of traffic lights has been used to indicate areas of concern and where readers of audit reports should focus their attention.

Audit report scenarios



Areas of most concern

Inability to attend stocktakes

One of the most immediate issues has been stocktakes - many entities were unable to hold year end stock counts at 31 March 2020. Or, if they did, the auditor under Lockdown level 4 was unable to attend. The auditing standards require the auditor to attend stocktakes unless it is impracticable for the auditor to do so. If they can't attend, then the auditor is required to include what is called a "limitation in scope" in the audit report. This means the audit opinion is qualified. Normally a qualified opinion is a **red** traffic light. However, it is an unavoidable outcome of Lockdown level 4 at 31 March 2020. So, it can be referred to as a technical qualification. There are likely to be many reports including qualifications for non-attendance at stocktakes. The circumstances of such a qualification are outside the control of both the entity and the auditor. The auditor will carefully word the qualification to make it explicit that it only relates to the existence of inventory, where and how much inventory.

Directors have expressed some concern that a bank receiving such a qualified audit report may see this as a covenant issue and react unfavourably. As an audit community we have tried to allay such concerns by explaining that it is unavoidable and not a reflection on an entity's financial standing. It is a result of the auditor being unable, due to the lockdown, to obtain the required audit evidence.

Multiple uncertainties

Where there are multiple uncertainties facing an entity or a lack of sufficient appropriate evidence to provide to the auditor this could result in a **DISCLAIMER** opinion. The auditor can't form an opinion because the issues are material and pervasive to the financial statements. This is a serious **red** traffic light.

Areas of moderate concern

Going concern

Covenant issues may also arise in other areas. Cash flows and results are coming under increasing pressure. We have encouraged entities to focus on bank financing early including consideration of covenant breaches either actual or potential. For example: if an entity has breached financial covenants (either pre or post 31 March) and hasn't been able to conclude renegotiation with the bank to have covenants reset prior to signing the financial statements this may impact on the audit report. The auditor will consider the overall financial position of the entity including covenant breaches, nature of covenants, headroom available and close calls, and forecast compliance amongst many factors. The auditor may as a result include what is called a "**Material uncertainty with respect to going concern**" paragraph in the audit report. This is not a qualification. This is akin to an **orange** traffic light - a **warning** light to the users of the financial statements. It is expected that stakeholders read the relevant notes to the financial statements (the auditor will identify these in their audit report) to understand what has given rise to the uncertainty.

Inclusion of material uncertainty caveat in the reports of valuers

Valuation of investment property (and other non-financial instrument valuations) was problematic at 31 March 2020. Valuers have included caveats in their valuations to highlight that there is less certainty than normal and there is likely a larger range of possible outcomes. This hasn't been seen (apart from in a few circumstances following the Christchurch Earthquake) in such a widespread manner before. Auditors may respond by including it in the KAM section of the audit report (see below). Where the audit report does not include KAMs, or the matter was not considered a KAM, the auditor may include an **orange** traffic light - called an **Emphasis of Matter (EoM)** paragraph in their audit report to draw the users' attention to the material uncertainty the valuer has identified in the investment property (or other) values. This is not a qualification. Again, this is largely a result of the "freeze" at 31 March, with no transactional activity.

Note:
1 Entities as defined under the Financial Markets Conduct Act.

Areas of least concern

Key audit matters

An increase in the number of Key Audit Matters (KAMs) is also expected in audit reports (where these are applicable) given the increased uncertainty and the judgements in the financial statements. KAMs are included as a section in the audit reports of all FMC[1] entities with a higher level of public accountability. KAMs provide transparency about the matters that, in the auditor's judgement, were of most significance in the audit of the financial statements. KAMs are selected by the auditor from the matters communicated with those charged with governance. A KAM is a **green** traffic light. KAMs are normal and to be expected. However, these should change as circumstances change. The material uncertainty in valuation reports noted above may be highlighted in KAM audit reports. (An auditor may not include an EoM on the same matter if they are required to report KAMs). Banks and other users of the audit report should read KAMs as they will provide information around the key matters that the auditor focused on and will therefore provide insights into some of the key risks in the financial statements.

COVID-19 is having an unprecedented impact on financial reporting. In this paper we have highlighted some of the key areas to be aware of relating to audit reports. If you have any questions or would like to know more, please get in touch.

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