

# Center for Plain English Accounting

## AICPA's National A&A Resource Center

### **Consequences of COVID-19 Potential Auditing Challenges**

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The CPEA continues to respond to questions related to the financial statement impact of COVID-19 and related reporting implications. Our [special report](#) issued on March 18, 2020 outlined some financial reporting matters that may need to be considered in light of the pandemic. This report addresses certain auditing challenges.

During the pandemic, challenges never before faced by auditors in performing audits are emerging. In response, auditors need to be more agile and creative in performing audits and complying with the auditing standards. The key is remembering that, while the auditing standards outline the performance requirements for obtaining reasonable assurance the financial statements are free from material misstatement, the auditing standards do not set specific requirements on how auditors might obtain that assurance. Now, more than ever, auditors might rely on technology in performing audit procedures.

#### **Possible Audit Scope Limitations**



Performing auditing procedures in the middle of this pandemic is troublesome for many auditors. In some cases, auditors may encounter scope limitations. This report will address some of those possible limitations, including:

- Performing physical inventory observations
- Accessing client records
- Understanding and testing internal control
- Confirming accounts
- Forecasting related to going concern
- Performing subsequent event procedures
- Obtaining management representations

## Professional Skepticism & Audit Evidence Quality

Before we begin discussing specific items, we remind auditors of their professional responsibility to plan and perform any audit (or assurance engagement) with professional skepticism.

### ***AU-C 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards***



**Professional skepticism** is “an attitude that includes a questioning mind, being alert to conditions that may indicate possible misstatement due to fraud or error, and a critical assessment of audit evidence.”

In today’s environment where many auditors are working remotely, firms are encouraged to remind everyone, from partners to less experienced auditors, about the importance of staying alert to the quality of evidence and whether that evidence is sufficient appropriate audit evidence to reduce audit risk to an appropriately low level. An audit isn’t about merely checking off audit procedures and the completion of forms and checklists. Rather, it requires professional judgment about the gathering of evidence and what that evidence indicates. While times are difficult for auditors, times are also difficult for clients. Therefore, firms are encouraged to remind staff and partners they are not advocates for clients. Rather, auditors are working in the public’s interest to serve the needs of users of the audit reports. Therefore, auditors may face difficult decisions about whether the audit evidence can reduce audit risk to an appropriately low level.

### **Financial Statement Issuance Delays**

With many businesses faced with unexpected closures and demand uncertainties, completion of procedures necessary to issue historical financial statements may be a low priority. The SEC has provided issuers [conditional relief](#) related to filing deadlines. Management and auditors of private companies may consider delaying financial statement issuance, if possible, until circumstances improve. In the interim, management of private companies could choose to communicate with users by means other than issued historical financial statements (such as drafts or projections). However, such an approach should be carefully considered. If there is a delay in the issuance of the financial statements, auditors will need to consider extending subsequent events and other auditing procedures as necessary.

### Physical Inventory Observation

AU-C 501, *Audit Evidence—Specific Considerations for Selected Items*, notes that, if inventory is material to the financial statements, auditors should obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by

attending physical inventory counting, unless impracticable and perform audit procedures over the entity's final inventory records to determine whether they accurately reflect actual inventory count results.

For audits of entities with fiscal year-ends that fall in the midst of the COVID-19 pandemic, auditors may encounter cases where retail locations and warehouses are closed, or are open with very limited staff, or auditors are unable to travel to the inventory observations due to travel restrictions. In those cases, obvious challenges arise in performing physical inventory observations.

**Alternative Count Dates and Intervening Transactions.** If clients are unable to perform physical inventory counts at year-end due to unforeseen circumstances, they might decide to perform those physical counts on an alternative date. Auditors may be able to observe the rescheduled counts and perform additional audit procedures on intervening transactions. If the physical inventory counts are to take place at a later date than originally scheduled, auditors will have to perform additional procedures such as reviewing and testing inventory rollforwards. For businesses that have closed store fronts and warehouses, this may not be a difficult task because there may be very few receipts or shipments coming in if facilities have been closed between year-end and the count date.

**Practice Note:** Auditors might need to perform procedures to obtain assurance that client inventory locations have in fact been locked down for a period of time. This might include obtaining live feeds of security camera footage taken of the retail locations and warehouses during that time and reviewing shipping and receiving records during that time to ensure movement was minimal.

**Unable to Attend Inventory Count.** In some cases, clients may be able to perform the usual physical inventory counts, but auditors are unable to attend due to travel restrictions. In those cases, auditors may want to take advantage of technologies including camera systems with live video feeds, to observe inventory counts. Of course, auditors should be aware that procedures that can be performed virtually might be a bit more limited and may pose additional audit risks that will need to be addressed. When there are multiple inventory locations, how will auditors control inventory counts to be certain inventory wasn't moved from one location to another? If the audit risks cannot be reduced to an acceptable level, this will pose a scope limitation.

**Leveraging Technology to Help with Inventory Counts.** The auditing standards do not prohibit use of technology when performing inventory observations. If auditors are satisfied with the inventory counting process, they may be able to utilize technologies to observe these counts. Of course, auditors may need to ensure there is some level of comfort that the videos are live feeds of client inventory locations, perhaps by confirming

visually with key staff and using voice technology to have cameras moved to specified locations on command and direct certain boxes to be opened.

**Scope Limitations and Alternatives.** In cases where clients are unable to perform physical inventory count at year-end or auditors are unable to obtain sufficient appropriate audit evidence that those counts were conducted properly (either unable to attend physical counts in person or remotely, or unable to test rollforward of inventory from balance sheet date to inventory observation date), these issues likely will present scope limitations that will impact auditor reports. In cases where inventory balances are material but are not pervasive, this will result in qualified audit opinions. Some alternatives auditors might discuss with clients include issuing qualified opinions now and, then, performing agreed-upon procedures engagements on inventory after travel restrictions ease or perhaps having clients discuss with financial statement users as to whether review engagements would be sufficient for the year-end, supplemented with agreed-upon procedures on inventory after year-end when counts can be taken. Of course, auditors should follow the guidance in paragraphs .14, .15, and .A35 through .A39 of AU-C 210, *Terms of Engagement*, when considering changing the terms of the engagement.

#### Access to Client Records

During the pandemic, accessing client books and records may present hurdles for some auditors, especially in cases where clients still maintain mostly paper records. Auditors may be able to obtain client-prepared copies or scans of key records, but auditors need to consider the authenticity of those records and perhaps perform additional audit procedures to be satisfied that those records are complete, accurate, and authentic.

In cases where auditors are unable to access client books and records, auditors may have to inform clients that audits cannot be completed until books and records can be accessed.

**Practice Note:** In cases where clients are required to have audited financial statements before specific dates, perhaps due to bank covenant requirements, auditors may want to encourage clients to contact users of the financial statements, such as bank credit officers, as soon as possible to see if waivers can be obtained.

#### Design, Implementation, and Testing of Internal Control

If client sites are closed and auditors are unable to perform audits on-site, performing walkthroughs and tests of internal control will be challenging. In these cases, auditors may not be able to rely on controls and may have to increase substantive testing.

Even when auditors have no plans to rely on operating effectiveness of controls, auditors still are required to have an understanding of internal control relevant to audits. An

understanding of internal control assists auditors in identifying types of potential misstatements and factors that affect the risks of material misstatement and in designing the nature, timing, and extent of further audit procedures. When risk assessment procedures identify significant risks, auditors then are obligated to evaluate whether controls relevant to those significant risks are suitably designed and implemented. And, since that evaluation can't be performed through inquiry alone, auditors need to determine what audit evidence remotely can be obtained. In other words, what audit evidence, beyond inquiry, can auditors remotely obtain that indicates controls are designed in a way that would prevent or detect and correct material misstatements in a timely manner, if operated effectively and, what evidence can auditors obtain to determine controls are in place (see AU-C 315.A77)? If auditors are unable to obtain sufficient appropriate audit evidence to perform and complete the risk assessment process, then auditors may have scope limitations.

**Advice Extracted from the AICPA's Guide, Assessing and Responding to Audit Risk in a Financial Statement Audit (paragraphs 3.114-3.115)**



When inquiry is used to obtain information about the design of internal control, the auditor may corroborate the responses to inquiries by performing at least one other risk assessment procedure in order to determine that client personnel are using the control. That additional procedure may be further observations of the control operating, inspecting documents and reports, or tracing transactions through the information system relevant to financial reporting. When no other procedure is more effective, corroborating inquiries, combined with observations, consideration of past actions or other evidence supporting the inquiries, may together provide sufficient evidence. When audit evidence is not available from any other sources, corroborative inquiries made of multiple sources may still have significant value when determining whether a control has been implemented.

One of the main pandemic-related audit issues that could arise relates to having sufficient access to all elements of client systems of internal control and whether auditors are able to understand and access those systems remotely (regardless of the level of automation). For example, how do auditors assess certain aspects of the control environment, the monitoring component or the control activities component remotely? Determining if a control has been implemented will be challenging if observation is required. If auditors are able to perform tests of controls during preliminary fieldwork, they might be able to place a level of reliance on controls. In addition, if management had to change some internal control procedures due to many personnel working remotely during the pandemic, auditors might be able to discuss any new

processes with management and confirm those new controls put in place during that time were operating effectively.

However, in an ever-changing and somewhat unstable environment, auditors should inquire as to any changes in the client system of internal control since the time that preliminary work was performed. In some cases, those controls may have changed dramatically, and procedures may have been changed to accommodate remote work forces and process flows. In such cases, auditors would need to evaluate how much reliance can be placed on those controls that were only in effect for a portion of the year.

### Account Confirmations

As noted in AU-C 505, *External Confirmations*, depending on the circumstances of the audit, audit evidence in the form of external confirmations received directly by auditors from confirming parties may be more reliable than evidence generated internally by the entity. In cases where a client site has been shut down or key staff are no longer on-site, obtaining external confirmations could be another alternative way to obtain audit evidence. However, there could be situations in which those audit confirmations are not filled out and sent back to the auditors, perhaps due to office closures and mail issues. In such cases, auditors would have to design additional audit procedures to gain sufficient, appropriate audit evidence related to the existence and valuation of key accounts such as accounts receivable.

Typically, if auditors are able to design and perform additional tests of those account balances, non-receipt of confirmations in and of itself should not result in a scope limitation. However, if auditors are unable to obtain sufficient audit evidence through review of the client books and records and are relying on receipt of audit confirmations as a key source of audit evidence, the non-receipt of those confirmations could result in a scope limitation (where balances are material to the financial statements).

**Practice Note:** Due to increasing business closures and movement to telecommuting models, auditors may consider sending electronic confirmations rather than paper ones. Some firms may have process flow software where this could be done quite easily and might result in a better response rate. Asking clients to first contact their vendors and suppliers in advance may be prudent, to understand the best way to contact these parties in the current environment. And although verbal confirmations are not the best source of audit evidence, perhaps during these times it might be the fastest and most effective way to obtain confirmation of account balances. In considering procedures, firms also should consider that, given sensitivity to cash flow in certain parts of the economy, more accounts receivable may remain outstanding when audit procedures are performed than in prior audits.

## Audit Planning

The first standard of fieldwork indicates that, "the auditor must adequately plan the work and must properly supervise any assistants." Auditors should take note that remote working does not excuse having required audit planning meetings. Auditors should ensure they still are holding these discussions as needed and having substantive discussions on engagement risks with the engagement team prior to commencing audit fieldwork.

## Fraud Brainstorming and Interviews

AU-C 240, *Consideration of Fraud in a Financial Statement Audit*, lays out a number of requirements and procedures that may be more challenging in a remote audit. For example, auditors still will need to carry out an appropriate discussion among the engagement team in order to understand what fraud risk factors may be affecting the entity in this environment. According to paragraph .A17 of AU-C section 240, inquiries of management and others within the entity are generally most effective when they involve an in-person discussion. However, due to the current circumstances related to the pandemic, these inquiries could be done via video conferencing technology.

**Practice Note:** When fraud interviews cannot be performed in person, use of video conferencing would be preferable to audio only conferencing as auditors would be able to see body language.

Also, the standard requires auditors to have discussions with management regarding management's assessment of the risks of fraud and management's process for identifying, responding to, and monitoring the risks of fraud. If for any reason, auditors are unable to complete these procedures, auditors would need to consider a scope limitation.

## Going Concern Assumptions and Related Disclosures

As noted in our [special report](#) dated March 18, 2020, the ability of an entity to continue as a going concern is affected by many factors, to include the industry and geographic area in which the entity operates, the financial health of customers and suppliers of the entity, and the accessibility to financing that is available for the entity. The consequences of COVID-19 may impact those factors and may cause a deterioration in an entity's operating results and financial position. As such, entities and auditors may need to consider recent pertinent information related to their assessments of going concern.

The look-forward period is one year from the date the financial statements are issued unless specified by the financial reporting framework (FRF-SME specifies a look-forward period of one year from the financial statement date). With circumstances changing

hourly due to COVID-19 with severe impacts in some industries (restaurants, entertainment, airlines, etc.), management's evaluation of conditions or events that may have an effect on the entity's ability to continue as a going concern under U.S. generally accepted accounting principles (U.S. GAAP) could be extremely difficult.

In some cases, managements' ability to evaluate and quantify going concern issues could cause difficulty in complying with the relevant U.S. GAAP rules (FASB *Accounting Standards Codification* (FASB ASC) 205, *Presentation of Financial Statements*, and more specifically FASB ASC 205-40). When management performs an evaluation of the entity's ability to continue as a going concern, but auditors are unable to gain access to that information or believe the supporting documentation is inaccurate or incomplete, auditors need to consider a scope limitation. Or, if auditors are able to conclude that substantial doubt remains, then a modified report should be issued for the substantial doubt.

**Practice Note:** However, auditors should keep in mind that management's assumptions are just that and, although making some of these evaluations or forecasts might be difficult to do in our current environment, in many cases, management's best estimate would be acceptable and would not result in a scope limitation.

#### CPEA Observation



The CPEA has been monitoring public company filings, and we encourage private companies to look at these examples when preparing financial statement disclosures. See the CPEA [special report](#), *Consequences of COVID-19: Illustrative Public Company Disclosures*, for helpful examples. Going concern reporting is an area that will continue to evolve as the economic impacts of this pandemic come into sharper view.

#### Subsequent Events

For calendar year-end 2019 financial statements, any COVID-19 related subsequent events identified likely will be events that provide evidence of conditions that arose after the date of the financial statements (historically referred to as Type II events). However, for entities with a year-end that is later than December 2019, management could have recognized subsequent events (historically referred to as Type I events).

## Definitions



**Recognized Subsequent Event:** Events that provide evidence of conditions that existed at the date of the financial statements (historically referred to as Type I subsequent events)

**Nonrecognized Subsequent Event:** Events that provide evidence of conditions that arose after the date of the financial statements (historically referred to as Type II subsequent events)

Many entities with year-ends after December 2019 will have pandemic-related events that require an adjustment to the financial statements or additional disclosures. Auditors will have to work with clients to ensure any subsequent events have been accurately identified and reflected in the financial statements as required by FASB ASC 855, *Subsequent Events*. If management is either unable or unwilling to identify those events and properly reflect them in the financial statements, this could result in a modification to the auditors' opinion.

### Management Representations

During this pandemic, additional representations could be added to the management representation letter, depending upon the particular circumstances of an engagement. Those additional representations may relate to the going concern assumption, subsequent events, risks and uncertainties, fraud, and significant estimates, among others.

**Electronic Signatures:** Using electronic means to obtain signed management representation letters is acceptable, if auditors can obtain management's receipt and acknowledgment of the letters. On a recent AICPA webcast, participants asked whether it was acceptable for management representation letters to be on "plain paper" rather than on company letterhead. The standards do not require use of letterhead. However, as a matter of best practice, it might be prudent for companies to note the company name and address at the top of the letter.

Depending on what is omitted from management's representation letter, the failure to obtain all representations does not necessarily result in a scope limitation. If management does not provide one or more of the requested written representations, auditors should:

- Discuss the matter with management
- Re-evaluate the integrity of management and evaluate the effect this may have on the reliability of representations (verbal or written) and audit evidence in general, and

- Take appropriate actions, including determining the possible effect on the opinion in the auditor's report in accordance with AU-C 705A, *Modifications to the Opinion in the Independent Auditor's Report*

## Fraud Risk

Auditors should be on higher alert for fraud risks given these uncertain times. For companies that have laid off key personnel and with work forces moving out of the typical office environment, there could be a breakdown in internal control. Auditors may need to adjust audit procedures as necessary to help reduce any potential fraud risks that could have a material effect on the financial statements.

## Conclusion and Additional Resources

CPEA will continue to monitor issues and questions related to the A&A impacts of COVID-19 and stand ready to issue additional guidance as new developments arise. The AICPA also has a [Coronavirus Resource Center](#) to keep the profession up-to-date on this issue, including information on business continuation, economic impact, workforce issues and other resources to help members serve their clients. View a [list of all available resources](#).

As always, the CPEA technical inquiry service is available for all CPEA members to answer your inquiries on this topic as well as most other accounting and assurance topics. The inquiry service can be accessed on our website. For non-CPEA members, you can call the AICPA technical hotline at 1-888-777-7077. Questions related to auditor independence (which certainly could arise in the current environment) should be directed to the AICPA Ethics Hotline at **1-888-777-7077** (select option 2, then 3) or [ethics@aicpa.org](mailto:ethics@aicpa.org).

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