EXTERNAL REPORTING BOARD
Te Kāwai Ārahi Pūrongo Mōwaho

XRB STAFF ALERT

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What can users of auditor reports expect from auditor reports in response to the impact of COVID-19?

HERE WE EXPLAIN THE COMMUNICATION TOOLS AUDITORS USE IN AUDITOR REPORTS AND THE LIKELY IMPACT OF COVID-19 ON AUDITOR REPORTING, INCLUDING

- MORE MODIFIED AUDITOR OPINIONS;
- MORE DISCLOSURES IN AUDITOR REPORTS; AND
- THE IMPACT OF GOING CONCERN MATTERS ON THE AUDITOR'S THOUGHT PROCESS AND AUDITOR'S REPORT

Given the current environment caused by the impact of COVID-19, we face an unprecedented level of uncertainty about the economy and future earnings, asset and liability values and viability of entities over the next 12 months and beyond. This raises challenges for preparers of financial statements, those charged with governance and auditors in dealing with these uncertainties, including any possible commercial implications for the entity.

The auditor plans and performs the audit to obtain reasonable assurance that the financial statements, including disclosures, are free from material misstatement.

A material misstatement is information in the financial statements that is sufficiently incorrect that it may impact the economic decisions of someone relying on the financial statements. For example, a material misstatement of revenue that increases profit could trigger a decision to buy a company's shares, causing losses for the investor when the misstatement is later corrected and the price of the share declines.

Impacts of the COVID-19 pandemic may amplify conditions giving rise to modifications in the auditor's opinion, and additional disclosures within the auditor's report. What do we mean by a modified opinion, and are all modified opinions "bad" for an entity?

There are a range of ways an audit opinion may be modified from what is usually understood as a "clean" opinion. Audit opinions are modified when the auditor:

- Concludes that there is information in the financial statements that is sufficiently incorrect that may impact the economic decisions of someone relying on those financial statements; or
- Has been unable to obtain sufficient and appropriate audit evidence to be able to conclude that the information in the financial statements does not contain a material misstatement.

THE NATURE OF THE AUDIT OPINION THAT AN ENTITY WILL RECEIVE WILL BE INFLUENCED BY THE JUDGEMENTS MADE BY MANAGEMENT AND THOSE CHARGED WITH GOVERNANCE, HOW THESE ARE REFLECTED IN THE DISCLOSURES MADE IN THE FINANCIAL STATEMENTS AND THE EVIDENCE AVAILABLE TO THE AUDITOR

- In the current environment of uncertainty, it may be difficult for management to know what the reasonable assumptions are about future cash flows that impact asset valuations and liabilities, as it is difficult to know how the economy will recover and the future impact on the entity. Management (and auditors) may struggle to obtain information to support these valuations.

- Also, management is required to assess the going concern basis of the entity. This is used when the entity is expected to continue in business without the threat of ceasing trading or liquidating the business in the foreseeable future. Management is required to assess this for at least the next 12 months, after the end of the reporting period. The current uncertain financial, operating and other conditions may make it difficult for management to make this assessment. It will also likely result in more auditor attention on the audit evidence to support management's assessment of the entity's ability to continue as a going concern and the relevant disclosures.

- The uncertainty may result in more modified opinions for entities, either as a result of auditors disagreeing with management's key judgements and assumptions (and consequently concluding the information reported is sufficiently incorrect to cause a material misstatement) or if there is not enough evidence to support management's key judgements and assumptions or because of uncertainty about the information. .

- The need for a modified opinion may also arise because certain audit procedures cannot be performed, in particular because of access issues and travel restrictions, as well as the availability of client staff. For example, auditors may have been unable to attend physical inventory counts during lockdown, group auditors may have challenges accessing workpapers of component auditors or understanding and testing internal controls may not be able to be undertaken due to changes in how entities are operating.

USERS OF FINANCIAL STATEMENTS MAY FIND THE FOLLOWING ADDITIONAL DISCLOSURES WITHIN THE AUDITOR'S REPORT, WHICH DO NOT AFFECT OR CHANGE THE AUDITOR'S OPINION, WHICH REMAINS UNMODIFIED.

Key Audit Matters (KAMs)

For audits of entities where KAMs are required, KAMs are those matters that, in the auditor's professional judgement, were of most significance in the audit of the financial statements.

The auditor describes, in a separate section of the auditor's report under the heading "Key Audit Matters":

- why the matter was considered to be one of most significance in the audit of the current period; and
- how the matter was addressed in the audit.

A KAM alone does not raise concerns about the financial statements but explains more about the audit and the steps the auditor had to take to obtain sufficient evidence. It still indicates a 'green light'.

Examples of changes in KAMs users can expect to see:

- New types of KAMs or new responses to previously reported KAMs
- How the change in the risks caused by COVID-19 has impacted the audit approach.
- New types KAMs not previously seen including inventory existence, expected credit losses in assessing doubtful debt provisioning due to COVID-19, etc.
- Expanded KAMs around disclosures and particular scenarios and sensitivities
- Reordering of KAMs – the most important KAM is the first KAM
- Repositioning where KAMs are included in the auditor's report

An Emphasis of Matter paragraph (EOM)

An EOM paragraph is used to draw the users' attention to a matter that is both fundamental to users' understanding of, and is appropriately presented or disclosed in, the financial statements.

EOMs are much less common in auditor reports for entities where KAMs are reported in the auditor's report. This is because for those entities where KAMs are required to be reported, and a matter meets the definition of a KAM and an EOM, it will be reported as a KAM. This allows the auditor to include additional information in the description of the KAM.

In the current circumstances, for audits where KAMs are not required to be reported, there are likely to be more EOMs.

Where the audit report does not include KAMs, an EOM may be used to signal an important matter for users to be aware of to better understand the financial statements, even where a 'clean' opinion is given.

Material Uncertainty Related to Going Concern (MURGC)

The auditor is required to include this additional paragraph in the auditor's report where management's use of the going concern basis of accounting is appropriate but where a material uncertainty has been identified, and this is appropriately disclosed in the financial statements. Reporting is under the heading 'Material Uncertainty Related to Going Concern' (MURGC).

Example of a MURGC included in the auditor's report

We draw attention to note xx to the consolidated financial statements which describe the impacts of COVID-19 on trading, a forecasted breach of banking covenants within the immediate future and measures taken by the Group which include a proposed capital raising, renegotiation of banking facilities including a covenant waiver and/or securing alternative funding. These conditions indicate the existence of a material uncertainty that may cast doubt on the Group's ability to continue as a going concern. Our conclusion is not modified in respect of this matter.

A MURGC is a special EOM, used specifically to highlight the future uncertainties about the entity's ability to continue as a going concern when the entity makes full disclosure. It is important to note that when management has not made adequate disclosures in the financial statements about a material uncertainty related to a going concern, the auditor will issue a modified opinion, as opposed to an unmodified opinion with communication on the MURGC disclosure in the audit report, as demonstrated above. The impact of going concern matters on the auditor's thought process and the auditor's report is explained further below.

Types of Modified Audit Opinions

ADVERSE OPINION

When an auditor has been able to obtain sufficient appropriate evidence and concludes that material and pervasive misstatements exists that undermine the reliability of the financial statements as a whole, they give an adverse opinion.

The auditor also gives an adverse opinion where the entity has prepared financial statements on a going concern basis, however the auditor does not agree that the going concern basis is appropriate.

QUALIFIED OPINION

When an auditor concludes that there is either a lack of sufficient appropriate audit evidence, or actual (or potential) material misstatements in a set of financial statements, but that is limited to a specific matter, then the qualification of the auditor's opinion only applies to those items.

In this case the auditor is reporting that "other than" the specific items described, they have concluded that the financial statements are otherwise true and fair.

DISCLAIMER

When an auditor has not been able to obtain sufficient appropriate evidence to be able to give an opinion but concludes that material and pervasive misstatements may exist, then they 'disclaim' their opinion entirely. This means that the auditor does not know whether there are any material misstatements, and cannot under the circumstances determine otherwise.

Given the current environment, it is likely that there may be a number of disclaimer of opinions where the auditor is unable to obtain sufficient appropriate audit evidence.

In reaching a conclusion, the auditor has a duty to remain objective and use professional scepticism to critically assess the available evidence and form an independent opinion. In doing so, the auditor has obligations to interact with those charged with governance. Open and constructive engagement with the auditor is to be expected, and can add value to the audit, even though in the end the auditor must step back and form their own independent opinion.

EXAMPLES OF MATERIAL MISSTATEMENTS THAT MAY CAUSE AN ADVERSE OR QUALIFIED OPINION, DEPENDING ON THE PERVASIVENESS OF THE MATTER

The application of the selected accounting policies

For example, inappropriate recognition and measurement in accordance with an entity's accounting policies of assets and liabilities whose values may be significantly affected by COVID-19.

The appropriateness or adequacy of disclosures in the financial statements

For example, when the financial statements do not include all the disclosures required to appropriately describe the effects of the current circumstances resulting from COVID-19, including sufficient description of relevant risks, estimates and judgements applied.

EXAMPLES OF INABILITY TO OBTAIN SUFFICIENT APPROPRIATE AUDIT EVIDENCE THAT MAY RESULT IN A QUALIFIED OPINION OR A DISCLAIMER, DEPENDING ON THE PERVASIVENESS OF THE MATTER

Circumstances beyond the control of the entity

For example, access to the entity's accounting records and/or audit evidence may be restricted due to government-imposed lockdowns during the COVID-19 pandemic (e.g., access to people, information, etc.).

Circumstances relating to the nature or timing of the auditor's work

For example, the impact of travel bans on the ability of the auditor to obtain sufficient appropriate audit evidence for components, associates or joint ventures.

In "normal" circumstances where the auditor will have been able to perform the necessary audit procedures to gain the evidence needed, the entity may not have received a qualified or disclaimer opinion. We urge you to read the reason for the modified opinion.

Impact of going concern matters on the auditor's thought process and auditor's report

What is meant by the 'going concern basis of accounting'?

An entity prepares financial statements on a going concern basis unless management either intends to liquidate the entity or to cease trading or has no realistic alternative but to do so.

In assessing whether the going concern assumption is appropriate, management takes into account all available information about the future, which is at least, but is not limited to, 12 months from the end of the reporting period.

When the use of the going concern basis of accounting is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realise its assets and discharge its liabilities in the normal course of business.

When an entity does not prepare financial statements on a going concern basis, it has to disclose that fact, together with the basis on which it prepared the financial statements and the reason why the entity is not regarded as a going concern.

The auditor has to:

- obtain sufficient and appropriate evidence to conclude on the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements; and
- conclude whether a material uncertainty exists about the entity's ability to continue as a going concern.

REQUIRED DISCLOSURES BY MANAGEMENT RELATING TO GOING CONCERN

Management is required to report on the judgements, assumptions, and other sources of estimation uncertainty that existed when preparing the financial statements that have the most significant effect on the amounts recognised in the financial statements, and that may result in a material adjustment to the carrying amounts of assets and liabilities within the next financial year.

Given the current environment, and the uncertainties about future events and conditions, there are likely to be more disclosures in the financial statements to explain management's judgements, assumptions, and other sources of estimation uncertainty (including going concern assessments).

MODIFIED OPINION IN RESPECT OF GOING CONCERN MATTERS

Disclaimer of opinion

Where a lack of evidence to support the going concern basis of accounting leaves the auditor unable to conclude on whether the use of the going concern basis is appropriate.

Adverse opinion

Where the auditor does not agree that the use of the going concern basis of accounting is appropriate.

Qualified or adverse opinion

Where the auditor concludes that the use of the going concern basis of accounting is appropriate, but a material uncertainty exists but the material uncertainty is not appropriately disclosed.

UNMODIFIED OPINION IN RESPECT OF GOING CONCERN MATTERS BUT WITH ADDITIONAL DISCLOSURES

KAM

Going concern can be a "close call". Here the auditor may have expended significant effort to gain comfort that the use of the going concern assumption was appropriate and that no material uncertainty exists.

MURGC

A MURGC is by nature a matter of key importance but where the auditor concludes that a MURGC exists and appropriate disclosure is made in the financial statements, this is communicated in a separate section of the auditor's report to bring this matter to the user's attention. It does not provide the 'green light' a KAM does. When a KAM is used there is no MURGC.