

Covid 19- Audit steps - GAAP accounts

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Date: 4th April, 2020

Webinar

WIRC of ICAI

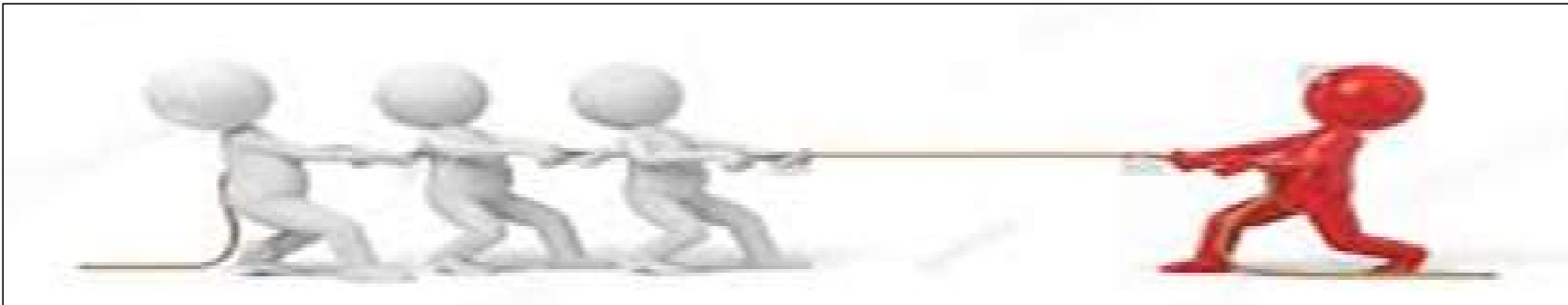
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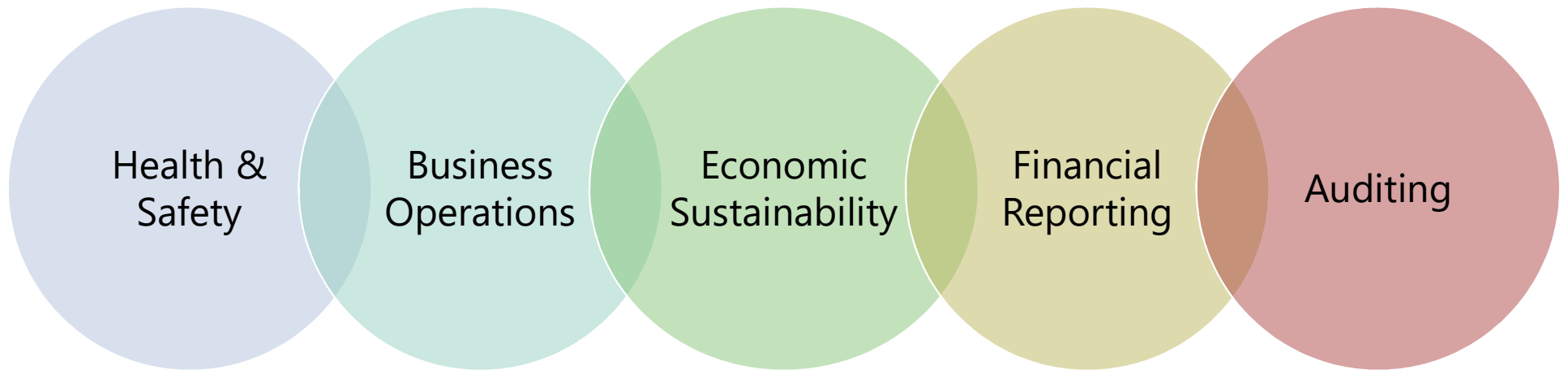
Background

Tug of War



Auditee / Preparers	Auditor
No impairment	Need for impairment test
Early closure of audit for banking limits	Additional time for alternate procedures
Long term view for going concern	Not a Going concern
Need credit period for payment of audit fees	No credit
Clean report	Modified Report

Impact of Covid-19 - Global pandemic



The impact of COVID-19 is **pervasive**

Alert from ICAI

The Institute of Chartered Accountants of India (ICAI) issued advisory alert for the:

- **Preparer** of the financial statements
- **Auditor** of the financial statements



Guidelines for the preparer address the common issues faced by the management and its accounting treatment under GAAP and Ind AS

Guidelines for auditors suggest the alternative audit procedures without compromising the quality audit

ICAI has also started **e-learning** on the above advisory

Link: https://learning.icai.org/committee/asb/impact_of_corona_virus_on_fr_ac/

Relaxations given by Regulators in India



सत्यमेव जयते

Government Of India

- Reliefs given in direct taxes and indirect taxes such as
 - Increase in time-lines for claiming benefit under Chapter VI-A of Income tax act, 1961
 - Donations to PM CARES fund eligible for 100% deduction
 - Extension in filing of returns under GST / Income tax act
- Extending the time period for claiming various benefits under the FTP 2015-2020
- Relaxation in timelines for holding board meeting, moratorium on late filing fees, deferred applicability of CARO 2020, etc.



- Moratorium for term loans, reduction in repo rate, reverse repo rate, CRR etc.
- Extended the period for expatriation of export proceeds from 9 to 15 months



- Extension in deadline for submission of financial results, corporate governance report etc.



- Extension of three months – for projects whose completion date is expiring post March 15th, 2020
- Extension for statutory compliances due in the period March to May – Upto June 30th, 2020

Guidelines given - across globe



Financial
Reporting
Council

PCAOB
Public Company Accounting Oversight Board



Association
of International
Certified Professional
Accountants®



Institute of
Chartered
Accountants
of England
and Wales



Australian Government
Australian Accounting
Standards Board



No carve-outs proposed by these regulators.



Case studies

Income recognition challenges



Goods are ready for dispatch & earmarked for customers – does it fulfill revenue recognition criteria ?

Goods delivered at customer site before lock-down but installation is pending as on 31st March 2020

In case of service income where work was completed prior to lock down but formal documents are dated post reporting period

Higher chances of sales returns

Deferment of income recognition



Income on account of membership fees, AMC etc.

- Validity period of contract extended by the entity
- Advance income due to services not provided during lock-down

Insurance claims



Business Interruption Insurance

If your operations are disrupted - completely or partially - the language of your policy will determine if, and for how long, your insurance company will cover the loss.

Even if you have taken any cover, the determination of claim will be a task. It shall be recognised if measurable and expect ultimate collection.

Negotiation in rentals payout



Difference in equalization reserve of Rs. 1,03,819 (i.e. Rs. 2,87,500 – Rs. 1,83,681) to be credited to profit and loss in year 19-20. (EAC Query no. 33 – Compendium of opinions - Volume XXIX)

Case study – Rent

Rs. 1 lakh for first 36 months and Rs. 1.25 lakhs for next 36 months. As of Feb 2020, 23 months expired. From March 2020, renegotiated at Rs. 0.75 lakh for next 13 months along with variable rent of 5% of turnover and Rs. 1.25 lakhs thereafter.

Upto Feb 2020

Particulars	Amount	Working note
Rent expenditure per month	1,12,500	$((1,00,000 \times 36) + (1,25,000 \times 36)) / 72$
Rent equalization reserve	2,87,500	$(1,12,500 \times 23) - (1,00,000 \times 23)$

Post Feb 2020

Particulars	Amount	Working note
Rent expenditure per month	1,07,986	$((1,00,000 \times 23) + (75,000 \times 13) + (1,25,000 \times 36)) / 72$
Rent equalization reserve	1,83,681	$(1,07,986 \times 23) - (1,00,000 \times 23)$

Extension of warranty period



TVS announces warranty extension and service support due between March and April upto 30th June 2020.

Bajaj auto extended the free service support due between 20th March to 30th April upto 31st May 2020.

Need to reassess the provision for warranty

Missed target based incentive

Production
incentive to
factory
workers

Incentives
to stockiest
or distributor
based on
secondary
sales

Entitlement to
sales executive
based on
brand / store
performance

Volume
discount from
vendors

Reassess the entitlements based on past trends. Commercial negotiation with counter party to extend the term upto June 30th 2020 for threshold limits.

Inventory valuation



Case studies:

- Prices of some of the products may fall down in near future
- Sale or return (SOR) arrangements
- Valuation of perishable items and shorter shelf life items
- Impact of Supreme Court order about BS-IV vehicles:
 - Permission to sell BS-IV vehicles - 10 days after lock-down
 - 10% of the existing inventory
 - Vehicle Registration date extended upto April 30th, 2020

Need to re-determine the net realizable value as it will impact the valuation of inventory (para 22/25 of AS 2.

Inventory valuation (continued)



During the lock-down, the plant will be shut down and accordingly there will be no production. However, fixed overheads e.g. rent will be incurred

Need to charge fixed overheads to profit & loss account – Actual production lower will be lower than normal capacity

Goods
In
Transit
Insurance



During the lock-down, the possibilities of material remained in transit and need to enquire about:

- *Theft or pilferage*
- *Damages at transporters end*
- *Insurance claim*

Impact on PPE & intangibles

Case study 1:

Tangible assets will remain idle during the lock-down

- *Depreciation & amortization charge will continue*
- *Useful / residual life need to be reassessed*
- *Impairment test*
- *Assets could not be fully installed due to lock-down – Question of tax depreciation in such scenario need to be evaluated*

Case study 2:

Capital projects kept on hold during the lock-down

Allocable cost including borrowing cost to be expensed out and not capitalized

Valuation & Impairment of Investments



Equity index is adversely impact due to COVID-19. The current investments required to be valued at **lower of fair value and cost**. The losses arising from the fair valuation, if material may be presented separately.

Investments in subsidiaries, associates and joint ventures – **Impairment test. Inability of JV or Associate partner to fund the entity(ex M&M-SsangYong, Korea)**

In case of reclassification of current investments to long-term, the transfer will be made at lower of cost or fair value on **the date of transfer**.

Working capital blocked: trade receivable



- Auditor should enquire with the management for any customers who are **financially sick** due to business disruption or **inability of the promoters**.
- Assessment of recoverability **not only for old** debtors, but also for the **recent ones**.
- **Receivables in foreign currency** needs to be reassessed for considering it as good and fully recoverable.

Impact on construction industry

- Significant change in **expected project costs** - impact on revenue recognition
- Losses of **onerous contracts** due to increase in contract costs to be recognised immediately
- Additional care to be taken for applying POCM
 - Material delivered to site but **could not be used / applied** due to lock-down.
 - Specific material purchased for the contract however **in transit** till 31st March 2020.
- Construction **overheads** incurred during Lock-down period ?

Onerous contracts

Economic benefits

Costs to execute contract

Increased cost of materials

Penalties for late deliveries

- Provisions will have to be made for the Onerous contracts.
- Impact of force majeure and price variation claims
- Lock-down period expenses – Whether provision required e.g.
 - Salaries & contract labour are routine expenses unless being terminated
 - Leases being surrendered during non cancellable term– with no waiver - required

Assessment of contingent liability

Case study: Entity imported the duty free goods against the EPCG / Advance licenses and due date to fulfil export obligation was 1st February 2020 which remained unfulfilled as at year end. Due to Covid-19, uncertainty exists as to execution of export orders within the extended period of only 6 months given by DGFT from date of expiry.

Considering the above uncertainty, it would be appropriate to recognise the provision in books instead of disclosing it under the contingent liabilities.

DGFT
extends time
for advance
licenses or
EPCG by 6
months



Donation

Case study: Ordinance dated March 31, 2020, deductions can be claimed for the financial year 2019-20 of donations under section 80G if payments made upto June 30th, 2020.

Company has made an announcement towards the Covid-19 relief measures however the money is not spent till the signing date.

Guidance note on CSR – Liability to be recognised for binding contracts



Other accounting concerns



Cash system of accounting

- Significant variation in receipts/payments – Adverse impact on income tax payment
- Receipts and payment parked in bank reconciliation statement



Actuarial valuation

- Fall in yields - Fall in discount rate - Increase in liabilities and expenses
- Mandatory leave in lock-down period (current / non-current classification)
- Reassess the attrition rate – likely retrenchment



Charitable trust

- Charitable trusts required to spend accumulated income to claim tax deduction
- The required expenditure could not be incurred within accumulation/extended period



Advertisement, hoardings and print media

- Amounts incurred towards advertisement, Outdoor Hoarding or print media during the lock-down period - need to reevaluate
- Commercial negotiations expected post lock-down which will impact accounting

Other accounting concerns

- Accounting of subsidy from State / Central Government if announced
- Presentation of 'Interest liability' on term loan from bank and o/s as on 31.3.20
 - Accrued and due
 - Moratorium of three months
 - Compounded interest obligation
- Postponement of events like IPL
 - Sponsors
 - Merchandize received / delivery pending

Presentation of loss due to Covid-19

Need for separate disclosure (exceptional item) in financial statement for aggregate financial loss incurred due to this crisis – **AS 4**

- Write off of inventory and provision for net realizable value
- Diminution in value of investments
- Impairment of property, plant and equipment and other assets
- Bad debts and provision for doubtful debts
- Material liquidated damages
- Provision towards onerous contract

Year 19-20 results not comparable with year 18-19

Business continuity

Severe cash flow constraint

- Hotels-restaurant, Tourism, Automobiles & dependent SMEs.
- Going concern assumption needs to be reassessed

Audit steps for validation

- Projected cash flow and profitability for next 12 months
- Comfort letter for continuous financial support from the promoters



Guideline for auditors

Guideline for auditors

- **Introduce questionnaire with key pointers**
- **Continue dialogue with client & team**
- **Internal training – use of technology**
- **Productivity**
- **Documentation of audit steps followed**

Planning



Execution



Reporting

Planning



Reassessment of risks and materiality

- Evaluation of additional risks on account of operational disruption, contractual non-compliance, liquidity issues, possibility of fraud etc.
- Revision in materiality level based on change in risk



Assessment of client

- Nature, size, business operations, internal controls, management, work force of the entity
- Reports of the internal audit (where applicable) to be considered



Questionnaire and checklist

- Prepare a separate set of questionnaire for management to identify the risks involved in each of the critical areas and measures taken to mitigate such risks



Extensive use of secured technology platforms for sharing client data

- Use of video conferencing, remote system access etc.

Alternative audit procedures



Year-end physical verification (SA 501)

Physical verification of inventory & cash were not possible on March 31.

Alternative audit procedure: Movement of stock / cash between the subsequent count date and reporting date are properly recorded.



External confirmation (SA 505)

Possibility of inadequate / no responses from external parties for the balance confirmation sent out

Alternative audit procedure: Subsequent receipts / payments, underlying documents for transactions during lock-down period.



Using the work of internal auditor (SA 610)

If internal audit conducted during the year the observations of it shall also be referred.

However unlike ISA 610, the Standard on Auditing 610 and Code of ethics issued by the ICAI, restricts sharing of audit working paper. In case of foreign entities, the auditor can request for audit working papers.

Audit procedures

Group audit- consolidated financial statement

- In case component(s) auditors are located in severely affected places, principal auditor may perform alternative methods like video conferencing, detailed questionnaire etc. and also consider impact of COVID19 on its components financials
- Early warning should be given by the component auditor to principal auditor for matter like deadlines which cannot be fulfilled, any material adjustments etc.

Management - Communication and Representation

- Auditor shall timely communicate with management / TCWG on the alternate procedures and obtain written representation for various estimates, assumptions and assessments made, including any specific representation, if necessary

Detailed self explanatory report

Modification

- Qualify / adverse / disclaim if situation demands

Emphasis

- Draw attention on certain matters (impact of COVID 19, going concern assumption, etc.)

Going concern

- Assessment of management's assumption

Other matters

- In case any unaudited entity consolidated [not material to overall group]

Other information

- Disclosure in FS and Board / Annual report

Internal Financial Control

- Operating effectiveness to be evaluated

CARO



- Physical verification conducted post year end for PPE & stock



- Deemed deposits – unsettled customer advances as at year end for more than 365 days



- Relaxation in statutory timelines – ESIC & GST



- Moratorium period for term loan - Not a default

Internal financial reporting - Opinion

Identify the new risks involved in this scenario (remote access to server, zoom security, etc.)

Alternate procedures over the operating effectiveness of controls during the lock-down period

Risk of fraud, errors,
misstatement

Internal controls designed and implemented to consider the impact of Covid-19

Extensive documentation for the design and effective implementation of the controls



Conclusion

Conclusion

Auditors dilemma / judgments

- Inherent limitations
- Alternate procedures may not suffice
- Excess reliance on management representation

Irrespective of challenges and uncertainties

- No compromise in audit quality
- No dilution or non-compliance with the auditing standards in carrying out the audits
- Modify the audit report if necessary

*Covid-19 still evolving,
Just now the financial impact can not be ascertained*

Questions





Thank You

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