A CAQ COVID-19 RESOURCE

Auditor Reporting COVID-19 Considerations

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The COVID-19 pandemic and the related market conditions create many new uncertainties for auditors, audit committees, investors and management of public companies. As SEC Chair Jay Clayton recently recognized, the continuing operation of the US capital markets is an essential component of our national response to, and recovery from, COVID-19. COVID-19 continues to impact public company financial statements in different ways and at differing levels of severity depending on an entity's capitalization, geographic location and the industry in which the entity operates, among other factors. This resource is intended to provide a high-level overview of the auditor reporting requirements under PCAOB auditing standards and how COVID-19 could impact the different types of audit reports to be issued.

This resource is intended as general information and should not be relied upon as being definitive or all-inclusive, or a substitute for PCAOB and SEC rules, standards, guidance, or other resources.

TECHNICAL REQUIREMENTS AND THE POTENTIAL IMPACT OF COVID-19

Reporting Considerations

The discussion in this resource is focused on United States annual auditor reporting requirements for public company financial statement audits. Certain issuers also are required by the SEC to have an audit of their Internal Controls over Financial Reporting (ICFR) and in such cases the auditor may choose to issue a combined audit report that includes both the auditor's opinion on the financial statements and the ICFR opinion, or issue separate opinions for each audit.

Unqualified audit opinion

Unmodified unqualified audit opinion

PCAOB Auditing Standard 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion (As Amended for FYE 12/15/2020 and After)*

(AS 3101), states the following with respect to unqualified audit opinions:

.02 The auditor is in a position to express an unqualified opinion on the financial statements when the auditor conducted an audit in accordance with the standards of the Public Company Accounting Oversight Board ("PCAOB") and concludes that the financial statements, taken as a whole, are presented fairly, in all material respects, in conformity with the applicable financial reporting framework.

Unqualified audit opinion with explanatory paragraph

While not affecting the auditor's opinion on the financial statements, there are certain circumstances in which the PCAOB auditing standards require the auditor to include explanatory language (or an explanatory paragraph) in the auditor's report. AS 3101.18 lists the circumstances that require such an explanatory paragraph in the auditor's opinion and the list includes situations when the auditor believes that there is substantial doubt about an entity's ability to continue as a going concern.

This is one example of a potential impact on audit reports stemming from COVID-19 and the resulting economic uncertainty as companies may face challenges that could impact their ability to continue operating as a going concern. If the auditor concludes that an entity's disclosures included in its financial statements around its ability to continue as a going concern are adequate and if after consideration of management's plans to alleviate such conditions, the auditor still has substantial doubt about the entity's ability to continue as a going concern, then the auditor would be required to include an explanatory paragraph in the audit report.[1]

Another example of this type of audit report that may be impacted by COVID-19 relates to other information included in documents that contain financial statements. COVID-19 has increased stakeholder focus on disclosures included in public filings, including disclosures that are outside of the financial statements. PCAOB Auditing Standard 2710, *Other Information in Documents Containing Audited Financial Statements,* states the following with respect to the auditor's responsibility for such information:

.04 The auditor's responsibility with respect to information in a document does not extend beyond the financial information identified in his report, and the auditor has no obligation to perform any procedures to corroborate other information contained in a document. However, he should read the other information and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements.

If the auditor were to determine that there was a material inconsistency between other information and the financial statements within a document, depending on the facts and circumstances, the auditor may be required under AS 3101.18 to include an explanatory paragraph in the audit report.

Unqualified audit opinion with an emphasis of a matter paragraph

An emphasis of a matter paragraph is generally included in an audit report at the auditor's discretion, and refers to a matter other than those already presented or disclosed in the financial statements that, in the auditor's professional judgment, is relevant to the user of the financial

1 See FN21 in AS 3101.13 which states that "Critical audit matters are not a substitute for required explanatory language (paragraphs) described in paragraph .18. If a matter that meets the definition of a critical audit matter also requires an explanatory paragraph, such as a matter related to going concern, the auditor may include the information required under paragraph .14 in the explanatory paragraph with a cross-reference in the critical auditor matters section of the auditor's report to the explanatory paragraph. Alternatively, the auditor may include the explanatory paragraph and critical audit matter communication separately in the auditor's report and add a cross-reference between the two sections."

statements understanding of the audit, the auditor's responsibilities, or the audit report. Emphasis of matter paragraphs are never required by the PCAOB auditing standards and are not a substitute for required Critical Audit Matters (CAM) or insufficient entity disclosures; however, other standards or regulations may require them in certain industries. AS 3101.19 states that "the auditor may emphasize a matter regarding the financial statements in the auditor's report ("emphasis paragraph")." AS 3101.19 also includes a listing of examples of matters that an auditor may choose to emphasize in the auditor's report. Historically, in the United States, the use of emphasis of a matter paragraphs have not been widely used in public company auditor reporting.

This type of audit report may be used in situations where an entity has adequately disclosed substantial doubt about its ability to continue as a going concern as a result of COVID-19 in its financial statements and the auditor concludes that management's plans to alleviate such conditions mitigate such risks; however, the auditor may determine that such going concern disclosures are of such significance that an emphasis of matter paragraph in the audit report is necessary.

Qualified audit opinion

PCAOB Auditing Standard 3105, *Departures from Unqualified Opinions and Other Reporting Circumstances*, states the following with respect to qualified audit opinions (AS 3105):

.02 A qualified opinion states that, *except for* the effects of the matter to which the qualification relates, the financial statements present fairly, in all material respects, financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. Such an opinion is expressed when:

a. There is a lack of sufficient appropriate evidential matter or there are restrictions on the scope of the audit that have led the auditor to conclude that he or she cannot express an unqualified opinion and he or she has concluded not to disclaim an opinion.

b The auditor believes, on the basis of his or her audit, that the financial statements contain a departure from generally accepted accounting principles (GAAP), the effect of which is material, and he or she has concluded not to express an adverse opinion.

In the COVID-19 auditor reporting environment, an example of where a qualified audit opinion could be required is where the auditor concludes that the entity's financial statement disclosures with respect to the entity's ability to continue as a going concern for a reasonable period of time are inadequate, such that a material departure from US GAAP exists in the financial statements.[2]

Another example of a potential impact to auditor reporting as a result of COVID-19 is a scope limitation resulting from the auditor's inability to observe material inventory balances recorded in a company's financial statements. The remote work environment has disrupted auditors' traditional approach to observing inventory. The PCAOB auditing standards have not changed as a result of the pandemic, so auditors have started to look to alternative methods, such as video technology, to audit the existence of inventory.[3] While auditors may be able to perform alternative procedures to obtain sufficient appropriate audit evidence over the existence of inventory, there may be situations where alternative methods to test inventory existence are not available, or practical. In such instances, if inventory is material to the company's financial statements, the auditor's inability to obtain sufficient appropriate evidential matter may require the auditor to qualify his or her opinion. The determination by the auditor to qualify or disclaim the opinion is based on the auditor's assessment as to the nature and magnitude of the potential effects of the matters in question and by their significance to the financial statements.

2 AS 2415.14: AS 2415, *Consideration of an Entity's Ability to Continue as a Going Concern*

3 Although the PCAOB auditing standards have not changed as a result of the pandemic, the PCOAB released a Spotlight document, COVID-19: Reminders for Audits Nearing Completion on April 2, 2020 which acknowledges that auditors may face challenges in obtaining evidence previously planned to be obtained through physical observation procedures.

Adverse audit opinion

AS 3105.01 defines an adverse opinion as an opinion that states that the financial statements do not present fairly the financial position, results of operations, or cash flows of the entity in conformity with US GAAP.

In the COVID-19 auditor reporting environment, this type of an audit opinion may be used in situations where the auditor concludes that the use of the going concern basis of accounting is inappropriate and that the company should be following a liquidation basis of accounting, as required by ASC 205-30, *Presentation of Financial Statements—Liquidation Basis of Accounting.*

Disclaimer of audit opinion

AS 3105.01 defines a disclaimer of opinion as an opinion that states that the auditor does not express an opinion on the financial statements. An auditor may decline to express an opinion whenever he or she is unable to form or has not formed an opinion as to the fairness of presentation of the financial statements in conformity with US GAAP.

As a result of COVID-19 this type of opinion may be used when there are significant scope limitations on the auditor's ability to obtain sufficient appropriate audit evidence such as the auditor's inability to obtain original documents from an entity that relate to material matters (e.g., third-party confirmations) when alternative procedures are not available, or practical.

Critical Audit Matters

While CAMs are part of the auditor's report, they are separate and distinct from the opinion on the financial statements and the basis for that opinion. AS 3101.A1 defines a CAM as any matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee and that: (1) relates to accounts or disclosures that are material to the financial statements and (2) involved especially challenging, subjective, or complex auditor judgment. CAMs are not a substitute for the auditor's departure from an unqualified opinion (i.e., a qualified opinion, adverse opinion, or disclaimer of opinion on the financial statements as described in AS 3105). The auditor's requirements related to CAMs were effective for audits of fiscal years ending on or after June 30, 2019 for large accelerated filers; and will be effective for audits of fiscal years ending on or after December 15, 2020 for all other companies to which the requirements apply. CAMs are not a substitute for explanatory paragraphs that are required under AS 3101. CAMS are not required to be included in the auditor's report when the auditor expresses an adverse opinion or disclaims an opinion.

While COVID-19 in and of itself, or going concern uncertainty, would not necessarily meet the definition of a CAM, the pandemic could increase the subjectivity and complexity of a specific audit area such that it meets the definition of a CAM, when it otherwise may not have prior to the pandemic. In addition, for audits of large-accelerated filers, COVID-19 also could result in CAMs that were previously identified and communicated in the auditor's report being expanded to include new assumptions that were especially challenging or complex due to the pandemic and/or result in changes to the auditor's response to a previously identified CAM.