

COVID-19 – Challenges of physical inventory counts on March 31, 2020

The COVID-19 pandemic is raising issues that auditors and their clients have most likely never encountered before. For auditors who perform audits of clients with year-ends occurring during the crisis, attendance at physical inventory counting is one of the first challenges they will face.

The questions and answers below provide an overview of certain relevant requirements and considerations. They do not address all topics or matters underlying those topics, nor do they address the ongoing evolution of the pandemic or the particular circumstances facing any one enterprise. Please exercise caution and refer to the updated assurance standards before making decisions.

1. What should the auditor do if their client does not intend to perform a physical inventory count at year-end but instead at a later date, once preventive measures are lifted?

Under the current standards, if physical inventory counting is conducted at a date other than the date of the financial statements, the auditor is required, in addition to attending inventory counting after year-end, to perform audit procedures to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded (CAS 501, paragraphs 5 and A9 to A11).

Elements to consider when planning audit procedures:

- *Will there be inventory movements, such as shipping and receiving, between the year-end date and the count date?*
- *Depending on the length of time between the year-end date and the count date, will the auditor be able to perform appropriate procedures to account for changes in inventory? These procedures could include, for example, inspecting shipping and receiving documents.*
- ✓ Given the safety measures implemented by the Government of Quebec, if a business is not considered to offer an essential service in Quebec, it is possible that no movement of inventory will take place between March 25 and April 13, 2020.
- ✓ If it is not possible to obtain sufficient appropriate audit evidence by performing these procedures, the auditor is required to consider whether it is appropriate to modify the opinion in the auditor's report (see Question 4).

2. What can the auditor do if the client performs physical inventory counting at year-end, but the engagement team is unable to physically attend the count for safety reasons related to COVID-19?

The auditor could consider attending the physical count virtually.

Modern technology such as drones and videoconferencing could allow the auditor to obtain some audit evidence remotely. Auditors who intend on adopting such technologies to virtually attend physical inventory counting will have to ensure that they do so with careful planning and heightened professional skepticism. Using innovative approaches and procedures can result in additional risks that auditors must consider in their audit approach.

Some additional precautions may be necessary to ensure the reliability of the audit evidence obtained remotely.

Elements to consider when planning to attend a physical count virtually:

- *Are members of the engagement team familiar with the technology used?*
 - *Will the client be able to show the building exterior so that the auditor can validate that the videoconference is indeed taking place in the selected location?*
 - *Will the auditor be able to do a virtual visit of the premises to evidence whether:*
 - *the inventory is well organized for the count?*
 - *there are inventory movements during the count?*
 - *the client's count process ensures that all inventory has been counted?*
 - *there are damaged or obsolete goods?*
 - *Can the auditor select test samples without undue client influence?*
 - *Will the engagement team's inability to move freely in the warehouses constitute a constraint and make it impossible to obtain sufficient appropriate audit evidence?*
 - *Will the procedures performed remotely allow the auditor to audit both the existence and the condition of inventory?*
- ✓ If it is determined that it is impossible to attend physical inventory counting virtually, the auditor must assess whether alternative audit procedures can be performed. Paragraph A13 of CAS 501 states that, in some cases where attendance is impracticable, alternative audit procedures, for example, inspection of documentation of the subsequent sale of specific inventory items acquired or purchased prior to the physical inventory counting, may provide sufficient appropriate audit evidence about the existence and condition of inventory.
- ✓ If it is impossible to obtain sufficient appropriate audit evidence by performing procedures remotely or other alternative audit procedures, the auditor is required to consider whether it is appropriate to modify the opinion in the auditor's report (see Question 4).

3. What should auditors do if a control reliance approach was planned with regards to auditing the quantities and condition of inventory?

The auditor would likely have to review the originally planned audit approach.

Below are some additional matters to consider:

- *Has the health crisis prevented the auditor from attending one or more planned physical cyclical inventory counts?*
 - *Has the health crisis prevented certain controls from being effective throughout the year?*
 - *Were new controls implemented or should they have been implemented in response to the health crisis?*
 - *If new controls were implemented, can they be tested?*
- ✓ If it is impossible to obtain sufficient appropriate audit evidence, the auditor is required to consider whether it is appropriate to modify the opinion in the auditor's report (see Question 4)

4. What will be the impact on the independent auditor's report if the auditor cannot attend physical inventory counting or perform adequate alternative audit procedures?

If the auditor cannot attend physical inventory counting or perform alternative audit procedures to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory, the auditor is required to consider whether it is appropriate to modify the opinion in the auditor's report, in accordance with CAS 705. The auditor should select the type of modified opinion that is appropriate for each situation, as applicable. Below is an example of a modified opinion in a situation where a qualified opinion is considered appropriate:

Qualified Opinion

We have audited the financial statements of ABC (the "Company"), which comprise the balance sheet as at March 31, 2020, and the statements of income, retained earnings and cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, except for the effects of the matter described in the *Basis for Qualified Opinion* section of our report, the accompanying financial statements present fairly, in all material respects, the financial position of the Company as at March 31, 2020, and its results of operations and its cash flows for the year then ended in accordance with Canadian accounting standards for private enterprises.

Basis for Qualified Opinion

In March 2020, the World Health Organization declared a global pandemic due to the novel coronavirus (COVID-19). This situation and measures put in place are having multiple impacts on local, provincial, national and global economies, including the closure of the company's facilities since March XX, 2020.

We were thus unable to observe the counting of physical inventories at year-end, and we were unable to satisfy ourselves by alternative means concerning the inventory quantities held at March 31, 2020, which are stated in the balance sheet at \$X. As a result of these matters, we were unable to determine whether any adjustments might have been necessary in respect of recorded inventories, and the elements making up the statements of income, retained earnings and cash flows.

It is important to note that a qualified opinion related to physical inventory counting does not release the auditor from performing key audit procedures relating to other assertions. The auditor must therefore continue to obtain sufficient appropriate audit evidence for all other assertions relative to inventory, including accuracy and valuation.

5. What should auditors do if they cannot attend physical inventory counting or perform adequate alternative procedures and the client is a reporting issuer?

Please contact the Autorité des marchés financiers as soon as possible:

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Autorité des marchés financiers

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Conclusion

In order to support the audit opinion, auditors should adequately document their assessment of risks, their planning and all procedures performed, including any changes made thereto to adapt to the current crisis.

Each situation will be different. The facts and circumstances specific to each audit, the risks identified and the understanding of the company's processes should all be well documented to support the strategy chosen by the auditor. Auditors should never settle for lower quality audit evidence under the pretext that this is an exceptional situation that affects all entities. In all circumstances, professional standards remain the same, and the same level of rigour is expected from all members.