नेपाल चार्टर्ड एकाउन्टेन्ट्स संस्था
THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NEPAL
(Established under the Nepal Chartered Accountants Act, 1997)

Advisory Note on COVID-19 impact on Financial Reporting and Auditing

The Novel Corona Virus inflicted disease COVID-19 first reported from Wuhan in central China has now spread all over the world putting the business and public life in stand still. Nepal has been successful to contain its spread through timely decision of the Government to put the country in lockdown from Chiatra 11, 2076 (24 March 2020).

The complete lockdown as a preventive measure to contain COVID-19 pandemic has imposed serious implications on business and other activities of the society as a whole, not only in Nepal but throughout the globe. All types of business – manufacturing, trading and services are in standstill except those treated as essential goods or services. Even the supply of essential goods and services are constrained due to restrictions in movement and physical contacts. The period of lockdown and its form will depend on the severity of the spread of the virus reflected in the number of confirmed cases, suspected cases in the isolation wards of the hospitals, the people in quarantine and the areas identified as hotspots.

Though it would be unbearable to continue the complete lockdown situation indefinitely till a known cure for COVID-19 is discovered, it is expected that the free movement of people and materials would be impacted for several months to come.

The restrictions caused by COVID-19 have rendered severe implications on the operation, management, recording, reporting and even continuity of the organizations. The audit, assurance and other professional services are also affected by these restrictions as the approach, methodologies and procedures employed in the normal situation are not appropriate or feasible in such situation.

The Institute of Chartered Accountants of Nepal (ICAN) has prepared this document to provide guidance to business organizations and its members in devising appropriate and uniform approach in preparing the financial statements by the organizations and audit of those statements by the members of the Institute.

These guidelines endeavor to analyze the current situation affecting the various accounting and auditing standards and the recommendations for consideration by the concerned entities and the members. It is reiterated that these guidance are for assisting the preparers of the financial statements and the members of the Institute to discharge their professional duties in an informed manner with due care in order to ensure that the financial statements are presented and audited in full compliance of the applicable standards. The preparers and the members are requested to fully comply with all the required standards with special attention to the recommendations on the following standards that are considered to be more likely to be impacted in different ways.

A. Nepal Financial Reporting Standards (NFRSs)

1. Impact on Going Concern: *NAS 1 Preparation of Financial Statements*
2. Impact on Inventories: *NAS 2 Inventories*
3. Impact on Revenue Recognition: *NAS 11 Construction Contracts and NAS 18 Revenue*
4. Events After the Reporting Period: *NAS 10 Events after the Reporting Period*
5. Recognition of Deferred Taxes: *NAS 12 Income Taxes*
6. Government Grants: *NAS 20 Accounting for Government Grants & Disclosure of Government Assistance*
7. Capitalization of Borrowing Costs: *NAS 23 Borrowing Costs*
8. Asset Impairment: *NAS 36 Impairment of Assets*
9. Provisions and Contingencies: *NAS 37 Provision, contingent liabilities and contingent assets*
10. Impact on Financial Instruments – Financial Assets and Financial Liabilities *NFRS 9 Financial Instruments*
11. Fair Value Measurements: *NFRS 13 Fair Value Measurements*
12. Other Impacts

1. Impact on Going Concern

Requirement

NAS 1 *Presentation of Financials Statements* requires us to assess the entity's ability to continue as a going concern considering all the information available for the foreseeable future and to prepare financial statements on a going concern basis unless it is probable that the entity will be liquidated or cease trading.

It also requires us to disclose material uncertainties that may affect the going concern concept.

If there are any plans to curtail the business activities the going concern assumption may be inappropriate.

Analysis of the Situation

Due to the outbreak of the COVID-19 pandemic, entities are suffering the loss of business, deterioration in the value of assets, and many other economic uncertainties which may have an impact on the working capital of the enterprise resulting in a liquidity crisis or considerable doubt on the business viability or continuity. Entities may fail to honor their commitments with lenders that are falling due or which will fall due shortly. Also it may trigger breaches of debt covenants or material adverse change clauses. Such breaches could cause debt to be classified as a current liability – i.e. if it becomes repayable on demand. The core business of the organization may no longer be feasible to continue or revive due to business losing its relevance in the market condition.

There are certain measures introduced by the government to ease the situation like deferment of the due date of payment of interests, loans, taxes, etc. which may provide some cushion to the entity to deal with the situation. Similarly, there could be alternatives to diversify the business to make it feasible in the changed context.

Recommendation

While assessing entity's ability to continue as a going concern, management shall take into consideration the existing and anticipated effects of the COVID-19 pandemic and the government's relief measures, and update its forecasts and sensitivities, review projected covenants compliances and also review its plan to mitigate events or conditions that may cast significant doubt on the company's ability to continue as a going concern. In addition, entities are recommended to take into account all available information for the foreseeable future, which shall be at least, but is not limited to, twelve months from the balance sheet date.

Breach of the debt covenants may make necessity to change the debt's classification, enough stressed shall be given in this matter while assessing the entity's ability to continue as going concern.

If the entity prepares financial statements on the going concern basis despite having material uncertainties about the future, the entity shall disclose these material uncertainties to make clear to the users of the financial statements that the going concern used by management is subject to material uncertainties.

Additionally, the entity needs to disclose how it is managing the risk, its response to the COVID-19 pandemic, and the breaches and defaults related to its covenants.

2. Impact on Inventories

Requirement

NAS 2 set out the measurement and recognition criteria for Inventories. It states that the inventories shall be measured at the lower of cost and net realisable value. It also requires that the amount of any write-down of inventories to net realisable value and all losses of inventories shall be recognised as an expense in the period the write-down or loss occurs.

Analysis of the Situation

Due to COVID-19 outbreak, most of the entities may be experiencing supply chain or trade disruptions. As a result, inventories might be exposed to the risk of loss due to obsolescence, damage, contamination, physical erosion, decline in selling prices or other causes. The cost of inventories may not be recoverable if those inventories are exposed with such risk. The cost of inventories may also not be recoverable if the estimated costs of completion or the estimated costs to be incurred to make the sale have increased

Recommendation

Entities shall need to assess whether, on their reporting date, it might be necessary to write down their inventories to net realisable value due to physical damage, obsolescence, reduction in price levels, or any other unfavorable conditions in accordance with the principles of NAS 2 'Inventories'.

Management should require more detailed methods or assumption to calculate or estimate NRV in unusual economic environment resulted from pandemic. In such situations, management must be aware that the inventories should not be carried in excess of amounts expected to be realised from their sale or use.

NAS 2 Inventories requires that fixed production overheads are included in the cost of inventory based on normal production capacity. Abnormally lower production than the normal capacity due to shutdown of production may require management to ensure that unallocated overheads are recognised as an expense in the period in which they are incurred.

3. Impact on Revenue recognition and Construction Contracts

Requirement

NAS 18 and NAS 11 set out the criteria and conditions recognizing Revenue for Sale of Goods, rendering of services and for interest, dividends and royalties and revenue from Construction Contracts.

As per these standards, Revenue is recognised when it is probable that future economic benefits will flow to the entity and these benefits can be measured reliably.

Analysis of the Situation

The COVID-19 outbreak has had adverse effects on many entities' operations and their revenue. There is high probability of increase in sales returns, additional price concessions, cancellation of prepaid services, penalties for late delivery, etc due to the downscale economic activity and reduced demand.

Entities may also be facing problems in delivering goods and services to customers or carrying out the construction work due to unavailability of workforce, disruption in supply chains or imposed restrictions. Due to COVID-19, there could be an effect on the assumptions made by management in measuring the revenue from goods or services already delivered.

Recommendation

Revenue should be recognised only when it is probable that the economic benefits associated with the transaction will flow to the entity. However, most entities may face the significant uncertainty of collection in view of the impact of COVID-19. When an uncertainty arises about the collectability of an amount already included in revenue, the uncollectible amount, or the amount in respect of which recovery has ceased to be probable, is shall be recognised as an expense, rather than as an adjustment of the amount of revenue originally recognised.

If there is probability that total contract costs will exceed total contract revenue, the entity should recognise such expected loss as an expense immediately as per NAS 11.

4. Events After the Reporting Period

Requirement

NAS 10 *Event after the reporting period* requires to adjust entity's financial statements for adjusting events after the end of the reporting period and states that no adjustment in financial statements is required for non-adjusting events after the end of reporting period.

Adjusting events are those events that provides further evidence of conditions that existed at the end of the reporting period.

And non-adjusting events are the events that are indicative of the conditions that arose after the end of the reporting period.

Analysis of the situation

The coronavirus infected disease was first diagnosed in Wuhan China and the Wuhan Municipal Health Committee had issued an urgent notice about the virus on 30 December 2019 and cases were reported to WHO on 31 December 2019. The World Health Organization announced on 30 January 2020 that the coronavirus is a global health emergency triggering the attention of the governments globally. Following the onset of the Pandemic globally in terms of steep rise in the confirmed cases and deaths, Nepal government issued an order to enforce nationwide lockdown on 10th Chaitra 2076 i.e. 24th March 2020 movement restriction and social distancing requirements as a most appropriate preventive measure.

Hence, in case of Nepal, the occurrence of COVID-19 event is well within the current fiscal year ending 15 July 2020. Therefore, entities need to evaluate all other events that are lined to COVID-19 pandemic or otherwise occurred after their reporting date and assess:

- the events that occurred subsequent to the reporting date but have linkages or bearing with the COVID-19 disruptions and need to be adjusted;

- whether there are any other events that provide additional evidence of conditions that existed at the reporting date and for which financial statements need to be adjusted, and events that that lead to disclosure only.

Recommendation

For interim financial statement having reporting date on Chaitra end (12 April 2020), the outbreak of the pandemic shall be considered as adjusting event as the order of lockdown was already issued on reporting date. As far as the end of the end of the financial year is concerned, widespread impact of the outbreak is already perceived by the economy so any significant event arising after 31 Ashadh 2077 (15 July 2020) that provides the evidence of condition existed at reporting date shall also have to be considered as an adjusting event.

Otherwise, if management concludes that an event as a non-adjusting event but the impact of it is material, the entity is required to disclose the nature of the event and estimate of its financial effect. If such estimate cannot be made reliably, then the entity is required to disclose the fact.

Furthermore, if any government assistance or other financial support has obtained by the entity after reporting date it should be taken into consideration while assessing the entity's ability to continue as a going concern.

5. Recognition of Deferred Taxes

Requirement

According to NAS 12 *Income Taxes*, deferred tax assets shall be recognized for all the deductible temporary differences to the extent that it is probable that taxable profit will be available in future against which temporary difference can be utilized.

Deferred tax assets will also be recognized for the carry forward of tax losses and tax credits to the extent it is probable that future taxable profits will be available against which these losses and credits can be used.

The standard requires that the carrying amount of the deferred tax assets should be reviewed at the end of each reporting period. The carrying amount of a deferred tax asset should be reduced to the extent that it is no longer probable that sufficient taxable profit will be available to utilize the asset.

Analysis of the Situation

Uncertainties caused by the COVID-19 pandemic may affect the entity's estimate of recoverability of the deferred tax assets. Changes in the entity's projection of future profit, changes in tax laws, the introduction of relief programs, etc. are few examples which may affect the reversal of deferred tax assets. Entity's estimate to adjust the carried forward losses against future profit, or to use the carried forward tax credits against future taxes may also be affected.

Recommendation

Management shall review the carrying amount of deferred tax at the end of the reporting period and decide whether it need to reduce the amount of assets recognized. While doing so management may do the followings.

- Assess the impact of COVID-19 on forecasted profit of the entity and update them.
- Assess the impact of changes in tax laws on the entity.
- Assess the impacts of relief packages introduced by government on entity's future profits and taxes.

Management shall provide clear and transparent disclosure about judgements and estimates made in recognizing and measuring deferred tax assets.

6. Government Grant

Requirement

NAS 20 *Accounting for Government Grants & Disclosure of Government Assistance* requires an entity to recognize the compensation for expenses or losses already incurred or for immediate financial support with no future related costs, as income in the period it is receivable.

Analysis of the situation

Due to the outbreak of COVID-19 pandemic, Government of Nepal has ordered the employers falling under organized sector to continue the payment of remuneration of their employees even if it is in excess of sick leave or annual leave entitlement. For which employers can use the fund deposited into welfare fund.

Also, contribution to be made to the Social Security Fund (SSF) for the month of Chaitra (Mid-March to Mid-April 2020) will be made by the SSF itself.

Question arises on accounting treatment and disclosure of the reimbursement of payroll cost from welfare fund and the employer's and employees' contribution to SSF by SSF fund itself.

Recommendation

Reimbursement of the payroll cost and SSF's contribution shall be treated as Government grant as per NAS 20. Consider additional disclosures on the accounting policies for government grants and the impact of grants and other assistance on the financial statements.

7. Capitalization of Borrowing Costs

Requirement

NAS 23 *Borrowing Cost* states that the capitalization of the borrowing cost should be suspended during extended period in which active development of the qualifying asset is interrupted. Capitalization is not suspended when a temporary delay is necessary part of the process of getting an asset ready for intended use or sale.

Amount capitalized should be the actual borrowing costs net of any income earned on the temporary investment of these borrowings.

Analysis of the Situation

Economic disturbance arising from the COVID-19 pandemic might have led to the suspension of the active development of the qualifying assets. Further modification of borrowing terms, arising out of negotiations or from government's relief program may change the amount of borrowing cost too.

Recommendation

Management shall reassess whether active development of the qualifying assets on which borrowing costs are capitalized are being suspended for a specific time period because of the COVID-19 outbreak control measures. If so, the management shall consider suspending the capitalization of borrowing cost for such specific period of time.

Entities can continue to capitalise borrowing costs if:

- the interruption is for only a short duration;
- it continues to perform substantial administrative or technical work; or
- it can demonstrate that the interruption is due to a common external event or is a typical part of the process.

If the management's assessment justifies continuance of capitalization of borrowing cost, modification, if any, of borrowing terms arising out of negotiations or from government's relief program shall be considered while calculating the amount of the borrowing cost.

8. Asset Impairment

Requirement

NAS 36 requires an entity to assess whether there is any indication that an asset (or cash-generating unit) may be impaired at the end of each reporting period. The test (formal estimate of recoverable amount) has to be performed only if any such indication of impairment exists, except in certain cases of intangible assets where the test has to be performed annually. Indicators of potential impairment loss could be external and internal factors.

NAS 36 further requires to estimate the recoverable amount of any asset or cash-generating unit to perform Impairment testing. It requires ascertaining whether the recoverable amount of an asset is less than the carrying amount. If so, the carrying amount of an asset has to be written down to the recoverable amount by accounting impairment loss.

Estimation of recoverable amount involves the determination of the fair value of assets, forecasting future cash flows, and also the determination of an appropriate discount rate, which involves a certain amount of judgment and estimation. NAS 36 states that the recoverable amount to be higher of fair value -less costs of disposal and its value in use, where the value in use is the present value of expected future cash flows.

Analysis of the Situation

Due to outbreak of COVID-19 pandemic and government's all possible measures to contain it, the overall business and economic condition of the nation has been deteriorating and significant adverse impact may have been caused to an asset or cash-generating unit of an entity. This may have resulted in the emergence of external and internal indicators of impairment causing necessity of impairment testing.

Also, the impact of the pandemic on the overall economy and to the enterprises individually may have affected the entity's earlier estimate of the fair value of an asset, expected future cash flows and the discount rate which ultimately have an impact on the recoverable amount of an asset or cash-generating unit. There is a possibility of recoverable amount to come down since many of the entities will result in significant drops in performance that would lead to reduction in cash flows forecasted in the calculation of value in use.

This requires making new estimates, assumptions, and judgments based on the latest available information, including the relief packages introduced by the government.

Recommendation

There is a high chance of emergence of external or internal factors necessitating impairment testing like a decline in market prices, trade barriers, lockdown situations, loss of production, etc. It is recommended to assess whether any external or internal factors have arisen and to estimate the recoverable amount of the asset.

Further, the impact can also be considered to be a temporary trigger for impairment in support of the government's relief programs.

Significant assumptions, such as input supplies, production level, forecast sales volumes, prices, gross margins, changes in working capital, foreign exchange rates, and discount rates will need to be reassessed and updated as appropriate due to the significant changes in economic and market conditions. The discount rate should reflect the impact of changes in interest rates and the risk environment at the reporting date. The management shall also review whether the useful life and residual value of these assets and the depreciation method applied to them, remain appropriate.

9. Provisions and Contingencies

Requirement

NAS 37 *Provision, contingent liabilities and contingent assets* requires an entity to recognize provision when the following conditions are met.

- An entity has a present legal or constructive obligation to transfer economic benefit as a result of past events; and
- It is probable that an outflow of resource embodying economic benefits will be required to settle the obligation; and
- A reliable estimate of the obligation can be made.

If these conditions are not satisfied, a provision shall not be recognized and the liability is then disclosed as a contingent liability.

Analysis of the situation

The impact of COVID-19 on the market condition, business and economy may call into question the entity's ability to abide by the stated terms of the contracts. Contractual obligations requiring outflow of resource embodying economic benefit may arise due to non-performance of the terms of the contract, and the application of NAS 37 becomes necessary.

It is also probable that the Government may issue order not to enforce the terms of the contract so as to ease the hardship suffered by entities.

Recommendation

Management shall carefully study the terms of contracts that couldn't be honored due to the uncertainties caused by COVID-19, and recognize the provision if-

- Legal obligation to transfer economic benefit as a result of the non-performance exist on reporting date; and
- Reliable estimate of the obligation can be made

Otherwise, it shall be disclosed as contingent liability.

10. Impact on Financial Instruments – Financial Assets and Financial Liabilities

Requirement

NFRS 9 classify and measure Financial Assets and Financial Liabilities on following characteristics:

(a) the entity's business model for managing the financial assets, and

(b) whether the contractual cash flows of the financial asset are solely payments of principal and interest.

Analysis of the Situation

Outbreak of COVID-19 pandemic has resulted in ongoing economic downturn which could significantly impact a borrower's ability to repay debt. Government of Nepal may introduce some financial relief packages like interest rebate, term deferral or loan rescheduling and restructuring for the borrowers that are affected from the lockdown. As a result, bank & financial institutions may enter into new negotiation with their borrowers to reschedule and restructure the existing loan.

Management should consider the impact of COVID-19 on the classification of these assets, in particular whether the entity's business model for managing financial assets might have changed.

Recommendation

Reclassification of financial assets is required when, and only when, an entity changes its business model for managing the assets. In such cases, the entity is required to reclassify all affected financial assets.

Management should make proper assessment of the impact of any changes to the terms of a loan agreement, either due to government relief packages or the renegotiation of covenants with the borrowers. Lenders should apply the guidance in NFRS 9 to determine the impact of the change in terms, including those for determining whether the change to the terms results in derecognition and, if not, for recognising a modification gain or loss.

11. Fair Value Measurements

Requirement

According to NFRS 13 *Fair Value Measurements*, the fair value of an asset (or liability) should reflect market conditions at the measurement date. The assets/liabilities should be valued in the order of priority of these three level inputs.

1. Level -1 Input

   Quoted prices in active markets for identical assets or liabilities that the entity can access at the measurement date. A quoted market price in an active market provides the most reliable evidence of fair value and is used without adjustment to measure fair value whenever available with limited exceptions.

2. Level-2 Input
   - Quoted prices for similar assets or liabilities in active markets.
   - Quoted prices for identical or similar assets or liabilities in markets that are not active.
   - Inputs other than quoted prices that are observable for the asset or liability.
   - Inputs that are derived principally from or corroborated by observable market data by correlation or other means.

3. Level-3 Input

   Unobservable inputs are used to measure fair value to the extent that relevant observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date.

   An entity develops unobservable inputs using the best information available in the circumstances, which might include the entity's own data, taking into account all information about market participant assumptions that is reasonably available.

Analysis of the Situation

Determination of fair value has become more challenging due to the uncertainty of the economic impact of COVID-19 Pandemic. For many assets and liabilities, fair values may have changed significantly, reflecting changes in cash flow forecasts, higher uncertainty and elevated risks. Fair value is a market-based measurement – it is measured using assumptions that market participants would use, reflecting market conditions at the measurement date. Performing a valuation that uses significant unobservable inputs is challenging, especially at times, as now, when markets are volatile, and the economic outlook is highly uncertain and prone to sudden change.

Recommendation

As we are almost 2 months away from the end of current financial year 15 July 2020, it is yet to be observed that how the market conditions unfold in the coming days. However, it is highly unlikely that the situation will get back to normal by then. Following are the suggestive measures to be taken.

- Consideration of whether the valuation reflects the participants' assumption based on information available and market conditions at the measurement date
- Consideration of whether the valuation incorporates the risk premiums that would arise from the increased uncertainty and other impacts of COVID-19

- Consideration of whether unobservable inputs have become significant, which would result in a Level 3 categorization and require additional disclosures
- Consideration of additional disclosures about the key assumptions, sensitivities and major sources of estimation uncertainty

12. Other Impacts

12.1 Impact on Depreciation and Amortization

NAS 16 and NAS 38 set out the allocation of cost of the assets as depreciation and amortization. Due to COVID-19, Property Plant and Equipment (PPE) and Intangible Assets may remain idle or not utilized for certain period of time. It may be noted that depreciation does not cease when the asset becomes idle or is retired from active use unless the asset is fully depreciated. However, under usage methods of depreciation the depreciation charge can be zero while there is no production. Further, COVID-19 impact may have affected the expected useful life and residual life of PPE and intangible assets.

12.2 Impact on Employee Benefits

As a result of unusual and depressing economic conditions, some entities may downscale their workforce. If the entity plans for workforce retrenchment, management must consider the timing and method of settlement of the liability or expense resulting from the termination benefits to employees. As per NAS 19, an entity shall account not only for its legal obligation under the formal terms of a defined benefit plan, but also for any constructive obligation that arises from the entity's informal practices. Entities should have discussions with their actuaries, to ascertain whether COVID-19 has impacted any assumptions in their reports such that their estimates may need to be revised.

12.3 Interim Financial Statements

An entity shall apply the same accounting policies in its interim financial statements as are applied in its annual financial statements. Therefore, recognition and measurement guidance described above applies equally to interim financial statements. NAS 34 Interim financial statements states that there might be greater use of estimates in interim financial statements, but it requires that the information is reliable and that all relevant information is disclosed.

If an entity changes the estimates, for example estimates relating to inventory write-downs, restructurings, or impairment losses in final interim period as a result of pandemic compared to that reported in an earlier interim period of the financial year, nature of change in estimate and (if practicable) the amount of a change in estimate that either has a material effect in the current interim period or is expected to have a material effect in subsequent interim periods should be disclosed in interim financial report as per NAS 34.

NAS 34 requires that an entity shall include in its interim financial report an explanation of events and transactions that are significant to an understanding of the changes in financial position and performance of the entity since the end of the last annual reporting period. This implies that additional disclosure should be given to reflect the financial impact of the pandemic and the measures taken. Entity specific disclosures should be made reflecting each entity’s circumstances.

12.4 General Disclosures

Management should consider the specific requirements in NAS 1 to disclose significant accounting policies, the most significant judgements made in applying those accounting policies and the estimates that are most likely to have the significant effect on the amounts recognised in the financial statements. All of these disclosures might be different depending on entity's nature of operation as well as a result of the impact of the COVID-19. An entity shall disclose information about the assumptions it makes about the future, and other major sources of estimation uncertainty at the end of the reporting period due to impact of COVID-19, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year. Considering the unusual circumstances, the entities should increase the extent of disclosures regarding estimation uncertainty. For instance, entity might witness the material changes in recoverable amount of assets, the effect of technological obsolescence on inventories, provisions subject to the future outcome of litigation process, employee termination benefits as consequences of pandemic within the next financial year. Management should involve assumptions about such items as the risk adjustment to cash flows or discount rates, future changes in salaries and future changes in prices affecting other costs while making estimates of uncertainty.

In addition to the disclosure requirements of individual standards, NAS 1 requires that an entity discloses separately on the face of the income statement or in the notes to the financial statements material items of income or expense. An entity might also disclose additional line items, headings or sub-totals on the face of the income statement and other comprehensive income where this is necessary for an understanding of entity's financial performance.

NAS 1 also requires entity to disclose information relevant to an understanding of the financial statements that is not presented elsewhere.

B. Nepal Standards on Auditing (NSAs)

Following is a non-exclusive list auditor should consider while carrying out audit engagements in the current situation of COVID-19, containing the provisions of Nepal Standards on Auditing (NSAs), analysis of situation and recommendation thereof. This is for the general guidance to the auditor and does not substitute the provisions contained in NSAs. The auditor is however always required to carry out their work exercising professional judgement and skepticism.

1. Risk Assessment and Control Environment: *NSA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*
2. Materiality: *NSA 320 Materiality in Planning and Performing Audit*
3. Accounting Estimates: *NSA 540 Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosure*
4. Audit Evidences : *NSA 500 Audit Evidences*
5. Physical Verification: *NSA 501 Audit Evidences Specific Consideration for Selected Items*
6. External Confirmation: *NSA 505 External confirmation*
7. Going Concern: *NSA 570 Going concern*
8. Subsequent Events*: NSA 560 Subsequent Events*
9. Written Representation: *NSA 580 Written Representation*
10. Auditor's Report:
    NSA 700 The Auditor's Report on Financial Statements
    NSA 705 Modifications to the Opinion in the Independent Auditor's Report
    NSA 706 Emphasis of Matter Paragraph and Other Matter Paragraphs in the Independent Auditor's Report

1. Risk Assessment and Control Environment

NSA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment

Requirement

Auditor shall perform "risk assessment procedure" to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels.

Risk assessment procedure shall include the following -

- Inquiries of the management and others within the entity who in the auditor's judgment may have information that is likely to assist in identifying risks of material misstatement due to fraud and error.
- Analytical procedures
- Observation and Inspection

Auditor shall obtain an understanding of internal control relevant to the audit. Also, the auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control.

Auditor is required to determine whether information obtained in the prior period remains relevant if the auditor intends to use that information for the purpose of current audit.

However, risk assessment procedure performed may not provide sufficient and appropriate audit evidence to base auditor's opinion.

Analysis of the Situation

Auditor may face different challenges due to the uncertainties caused by the COVID-19, while performing risk assessment procedure, some of them are –

- Communication with the management and others within the entity which is affected by the social distancing measures.
- While performing analytical procedures, where auditor need to apply his judgement for which auditor's previous understanding of the client's business may change significantly for reasons like strained cash flow and business continuity risks, changes in business models, changes in the operating system and control systems, etc.
- Observation and inspection as normal audit procedures may not be possible due to the social distancing requirements and travel restrictions.

Management's control system may have changed significantly which might affect the auditor's previous understanding of the control system, and also causes the difficulties to obtain understanding of new control system including the judgement of its effectiveness.

Recommendation

- Communication with management and other relevant personnel should be maintained using alternative means using technology based applications like virtual meeting platforms.
- Evaluate the assessment by Those Charged with Governance (TCWG) and management the materiality of the risks from COVID-19, and consider the reasonableness of their assessment.

- Inquire the management about the significant impact on entity and obtain the understanding of impact of the outbreak on industry and overall economy as a whole so as to perform analytical procedure.
- Inquire about any changes in the client's internal control system. If the control system has changed significantly auditor needs to evaluate how much reliance can be placed on those controls that were only in effect for a part of the year.
- Obtain understanding of controls remotely, however, it may not be sufficient to determine whether such controls have been placed in operation. So, auditor needs to consider what evidence can be obtained remotely to determine effectiveness of the control system that have been placed in operation.
- Evaluate the instances and severity of control deficiencies and decide how this affects the auditor's plan to perform audit procedures.
- Pay specific attention while assessing the risk of material misstatement due to fraud & other intention.

2. Materiality

NSA 320 Materiality in Planning and Performing Audit

Requirement

While establishing the overall audit strategy, the auditor shall determine materiality for the financial statements as a whole or materiality or materiality level or levels for classes of transaction, account balances or disclosures.

Auditor shall determine the performance materiality for the purpose of assessing the risks of material misstatement and determining nature, timing and extent of further audit procedure.

Analysis of the situation

Due to outbreak of COVID-19, entities are facing unprecedented situations like loss of their business, loss of value of assets, alterations, adjustments or compromise in the control systems, etc. which may have significantly affected the amounts and information disclosed in the financial statements requiring auditor to consider these factors while setting the materiality level or reassess the materiality level, if already set.

Recommendation

- Consider reducing materiality threshold for the amount and disclosures affected by the current market situation and the changes in the control environment within the entity.
- Consider whether it is appropriate to exclude the items that are affected by COVID-19, while setting up the materiality level.
- Consider whether separate material level or levels can be applied to the particular class or classes of transactions, account balances or disclosures.

3. Accounting Estimates

NSA 540 Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosure

Requirement

When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, including the entity's internal control, as required by NSA 315, the auditor shall obtain an understanding of the following in order to provide a basis for the identification and assessment of the risks of material misstatement for accounting estimates:

- The requirement of the applicable financial reporting framework relevant to accounting estimates, including related disclosures.
- How management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognized or disclosed in the financial statements. In obtaining this understanding, the auditor may require making inquiries of management about changes in circumstance that may give rise to new, or the need to revise existing accounting estimates.
- How management makes the accounting estimates and an understanding of the data on which they are based.

Analysis of the situation

Due to the changes in economic conditions, business environment and uncertainties arising out of COVID-19 pandemic, accounting estimates made by management may require revision and also management may need to make new estimates because of difficulty caused by the situation where measurement could have been made with precision in normal circumstances.

Making estimate is a daunting task because it requires to deal with uncertainties, especially in difficult time like this pandemic it is even more challenging.

Auditor is required to satisfy himself/herself with the reasonability of the estimates and the disclosure made.

Recommendation

- Consider whether the disclosures are sufficient and appropriate in accordance with the financial reporting framework for the circumstances created by the COVID-19.
- Consider whether the assumption and the data used by management to make estimate are accurate and reasonable in accordance with the circumstance.
- Consider whether the estimates made in earlier year by management have been reassessed to reflect the changed business environment.
- Consider obtaining management's representation letter on the estimates made by management with specific mention of the areas or issues directly impacted by the pandemic.

4. Audit Evidences

NSA 500 Audit Evidences

Requirement

The auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient and appropriate audit evidences.

While designing and performing audit procedures, the auditor shall consider relevance and reliability of the information to be used as audit evidence.

Analysis of the situation

Due to travel restriction and safety measures imposed by the Government to contain COVID-19, it may be difficult for auditor to access the records of the client, especially when it is maintained in traditional paper form. Also, there may be risk of not making required documents citing the difficulties caused by the COVID-19 preventive measures.

Recommendation

- Request the client to allow access to the client's system remotely to obtain and/or verify the required data and information.
- Consider using scanned copies of the documents but auditor need to consider the authenticity of the scanned documents.
- Consider performing additional audit procedure to satisfy the authenticity of the records. Consider conducting virtual meetings with the clients so as to perform virtual inspection of original documents.
- If the client maintains the records on cloud platform, auditor can access client's record virtually and perform the audit procedures.

5. Physical Verification

NSA 501 Audit Evidences Specific Consideration for Selected Items

Requirement

When inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidences regarding the existence and condition of inventory either by attending the physical inventory counting, unless impracticable or by performing audit procedure over the entity's final inventory records to determine whether they accurately reflect actual inventory count records.

If auditor is unable to attend the physical inventory counting due to unforeseen circumstances, the auditor shall make or observe some physical counts on an alternative date, and perform audit procedure on the intervening transaction.

If attendance at physical inventory counting is impracticable, the auditor shall perform alternative audit procedure to obtain sufficient appropriate audit evidences regarding the existence and condition of inventory, if it is not possible to do so, the auditor shall modify the opinion in the auditor's report.

Analysis of the situation

Physical verification of Inventories may not possible due to social distancing and travel restrictions imposed by the Government.

In some cases, clients or internal auditors may be able to perform the physical inventory counts, but auditors may not be able to attend the physical count due to travel restrictions or even the clients may not be able to perform the physical verification on the year end date.

Recommendation

Consider conducting verification on alternative date and auditors may observe the verification on alternative date and perform alternative audit procedures on intervening transactions like reviewing and testing inventory roll forwards.

If the client has conducted physical verification and however its impracticable to auditor to attend the verification consider taking advantages of the technologies to observe inventory counts virtually.

Auditors should be aware that such procedures may pose additional audit risks that will need to be addressed. When there are multiple inventory locations, auditors may need to address control of inventory counts to obtain evidence that inventory wasn't moved from one location to another during the inventory counts. If the audit risks cannot be reduced to an acceptable level, this will pose a scope limitation.

If the auditor become unable to perform any of the above mentioned alternative procedure and considers that the inventory in consideration is material, it will be considered as a scope limitation and may impact the audit opinion.

6. External Confirmation

NSA 505 External confirmation

Requirement

NSA 500 *Audit evidences* states that the audit evidences in form of external confirmations received directly by the auditor from confirming parties may be more reliable than evidences generated internally by the entity.

NSA 505 *External confirmation states that w*hile using external confirmation procedure, the auditor shall maintain control over external confirmation requests.

If auditor identifies factors that give rise to doubts about the reliability of the response to a confirmation request, the auditor shall obtain further audit evidences to resolve those doubts.

In case of non-response, the auditor shall perform alternative audit procedures to obtain relevant and reliable audit evidence.

Analysis of the situation

Due to this countrywide lockdown there may be possibility that the respondent's offices are also closed and they may also have moved to virtual modes.

Auditor may consider using technology to reach the parties and obtain the confirmation via emails; however, the reliability of the confirmation may pose another risk.

Recommendation

- Maintain effective control over selection, distribution and receipt of responses for confirmation of account balance and transactions.
- Consider sending electronic confirmation rather than paper confirmation.
- Design and perform additional audit procedures to verify the authenticity of the confirmations received through electronic means.
- If no responses are received, perform alternative audit procedure so as to confirm account balances and transactions.

7. Going Concern

NSA 570 Going concern

Requirement

The auditor's responsibilities are to obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements, and to conclude, based on the audit evidence obtained, whether a material uncertainty exists about the entity's ability to continue as a going concern. These responsibilities exist even if the financial reporting framework used in the preparation of the financial statements does not include an explicit requirement for management to make a specific assessment of the entity's ability to continue as a going concern.

Analysis of the situation

Due to the outbreak of the COVID-19 pandemic, entities are suffering the loss of business, deterioration in the value of assets, and many other economic uncertainties which may have an impact on the working capital of the enterprise resulting in a liquidity crisis. Entities may fail to honor their commitments with lenders that are falling due or which will fall due shortly. Also, it may trigger breaches of debt covenants or material adverse change clauses. Such breaches could cause debt to be classified as a current liability – i.e. if it becomes repayable on demand.

Auditor's concern is with the appropriateness of management's assessment of the entity's ability to continue as going concern.

Recommendation

Consider whether management's assessment of the entity's ability to continue as a going concern includes all relevant information of which the auditor is aware as a result of the audit.

If events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor is suggested to obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern.

If the auditor concludes that a material uncertainty exists, the auditor is required to determine whether the financial statements adequately disclose the events or conditions that may cast significant doubt and management's plans to deal with them, and discloses clearly that there is a material uncertainty.

Even though appropriate disclosures about material uncertainty are made in the financial statements, the auditor is required to draw attention to the notes in the financial statements which discloses these matters.

If the auditor concludes that no material uncertainty exists, the auditor is still required to evaluate whether the financial statements provide adequate disclosures about these events or conditions. In these circumstances, the auditor may consider that the disclosures of these events or conditions are fundamental to users' understanding of the financial statements and that it is necessary to draw their attention to such disclosures by including an Emphasis of Matter paragraph in the auditor's report that refers to the disclosures.

8. Subsequent Events

NSA 560 Subsequent Events

Requirement

Obtain sufficient appropriate audit evidence about whether events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements are appropriately reflected in those financial statements; and respond appropriately to the facts that become known to the auditor after the date of the auditor's report, that had they been known to the auditor at that date, may have caused the auditor to amend the auditor's report.

Analysis of the situation

The coronavirus infected disease was first diagnosed in Wuhan China and the Wuhan Municipal Health Committee had issued an urgent notice about the virus on 30 December 2019 and cases were reported to WHO on 31 December 2019. The World Health Organization announced on 30 January 2020 that the coronavirus is a global health emergency triggering the attention of the governments globally.. Following the onset of the Pandemic globally in terms of steep rise in the confirmed cases and deaths, Nepal government issued an order to enforce nationwide lockdown on 10th Chaitra 2076 i.e. 24th March 2020 movement restriction and social distancing requirements as a most appropriate preventive measure.

Hence, in case of Nepal, the occurrence of COVID-19 event is well within the current fiscal year ending 15 July 2020. Therefore, entities need to evaluate all other events that are lined to COVID-19 pandemic or otherwise occurred after their reporting date and assess:

- the events that occurred subsequent to the reporting date but have linkages or bearing with the COVID-19 disruptions and need to be adjusted;
- whether there are any other events that provide additional evidence of conditions that existed at the reporting date and for which financial statements need to be adjusted, and
- events that that lead to disclosure only.

Recommendation

- Consider applying high level of skepticism and obtaining sufficient appropriate audit evidences about whether all the significant events occurred between reporting date and the date of audit report are adequately recognized and disclosed on financial statements.
- 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 auditor's opinion.

9. Written Representation

NSA 580 Written Representation

Requirement

The auditor shall request written representations from management with appropriate responsibilities for the financial statements and knowledge of the matters concerned.

Analysis of the situation

Due various difficulties imposed by COVID-19 auditor may not be able to perform the traditional audit procedures as in the normal situation. On the other hand, there will be certain additional considerations needed while preparing and auditing the financial statements impacted by the COVID-19 disruptions. This puts the auditor in a situation of additional risk in balancing the skepticism and the degree of employing audit procedures. The management letter may also need to reflect the additional information to incorporate the situation caused by the pandemic.

Obtaining physical hard copy of representation letter from management may be difficult due to travel restrictions and social distancing measures.

Recommendation

Additional matters in the written representation should be asked with the management e.g. going concern assumptions, risks and uncertainties frauds, accounting estimates, etc. wherever considered appropriate.

Management's representation letter obtained through electronic media can be accepted, however, auditor shall satisfy himself/herself with the authenticity of the signed management representation letter.

10. Auditor’s Report

NSA 700 The Auditor’s Report on Financial Statements, NSA 705 Modifications to the Opinion in the Independent Auditor’s Report and NSA 706 Emphasis of Matter Paragraph and Other Matter Paragraphs in the Independent Auditor's Report

Requirement

NSA 700 deals with the auditor’s responsibility to form an opinion on the financial statements. It also deals with the form and content of the auditor’s report issued as a result of an audit of financial statements. In addition, NSA 705 and NSA 706 deal with how the form and content of the auditor’s report are affected when the auditor expresses a modified opinion or includes an Emphasis of Matter paragraph or an Other Matter paragraph in the auditor’s report.

Analysis of the situation

There could be several situations arising from the ongoing COVID-19 outbreak that could have an impact on auditor’s report and the instances where the Auditor may need to express a modified opinion due to COVID-19 situation, some instances are;

- The entity has not accounted or reported or disclosed the financial impact arising out of the COVID-19 outbreak in the financial statements as prescribed by NFRS/NASs.
- The auditor is unable to obtain sufficient appropriate audit evidence relating to the impact of COVID-19 in the financial statements and is of opinion that there are misstatements that are material to the financial statements.
- The auditor has findings on material misstatement and communicated to the management and those charged with governance relating to COVID-19 and the management or those charged with governance refuses to correct such misstatements that are individually or in aggregate, material to the financial statements.

Recommendation

When the auditor expects to include the emphasis of matter paragraph or modify the opinion in the auditor’s report, the auditor should communicate with those charged with governance the circumstances that led to the expected modification. Some of the instances where auditor should express the opinion other than unqualified opinion are;

- A qualification or adverse opinion should be expressed if the auditor having obtained sufficient appropriate audit evidence, concludes that the disclosures regarding impact of COVID-19 are inadequate or there are material uncertainties in going concern assumption by the management.
- A disclaimer of opinion should be provided if there is a scope limitation where auditor is unable to obtain sufficient appropriate audit evidence or it is not possible to form an opinion on the financial statements due to the potential interaction of the uncertainties resulted due to COVID outbreak.

- An emphasis of matter paragraph should be included to highlight a significant subsequent event disclosed in the financial statements or a significant uncertainty in relation to a going concern resulted due to pandemic.
- Additionally, the significance of the impacts of COVID-19 may warrant including additional explanatory paragraph in the auditor's report when there is substantial doubt about the ability of the entity to continue as a going concern.
- Where appropriate, auditors may decide to include a key audit matter in their audit report.