

March 18<sup>th</sup>, 2020

To JICPA members

The Japanese Institute of Certified Public Accountants

### Audit Consideration related to COVID-19 (Part 1)

Today, JICPA released “Audit Consideration related to COVID-19 (Part 1)”. Please find below the English translation which shall be used solely as a reference material to aid in the understanding of our original release in Japanese.

Currently in Japan, we are in the process to take measures to prevent further spread of COVID-19, and the business activities of companies and auditors have been affected. Auditors have reported cases that they cannot perform procedures as originally planned.

The overall objective of the auditor in auditing financial statements is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or errors, thereby enabling the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. In order to obtain reasonable assurance, the auditor develops an audit plan and, through audit work performed throughout the year, obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level. Whether sufficient appropriate audit evidence has been obtained to base the auditor’s opinion is a matter of professional judgment. Even when affected by measures to prevent the spread of COVID-19 to some extent, the auditor should exercise professional judgment in order to obtain sufficient appropriate audit evidence with the cooperation of audited companies while bearing in mind the risk of the further spread of COVID-19.

The followings are the matters for the auditors to consider under the current situation as “Audit Consideration related to COVID (Part1)”. Additional matters may be added as the situation changes.

## **1. Considerations on Audit Procedures**

### **(1) Inventory Observation**

As a result of implementing preventive measures to avoid further spread of COVID-19, it might be necessary to consider how the physical inventory counting and observation by the auditor can be conducted.

When inventory is material to the financial statements, the auditor is required to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by attendance at inventory counting unless impracticable (Auditing Standards Committee Statement (ASCS<sup>1</sup>) 501 “Audit Evidence—Specific Considerations for Selected Items,” Paragraph 3). In the observation of physical inventory counting, it will be important to gain the understanding and cooperation of audited companies.

#### When the date of physical inventory counting differs from the fiscal year-end date

As a result of implementing preventive measures to avoid further spread of COVID-19, physical inventory counting may be conducted other than the fiscal year-end date (i.e. a day after the fiscal year-end). In such a situation, the auditors are required to perform audit procedures to obtain audit evidence about whether changes of inventory between the count date and the date of fiscal year-end are properly recorded (ASCS 501, Paragraph 4).

#### When alternative audit procedures are performed (since the observation of physical inventory counting is impracticable)

As a result of implementing preventive measures to avoid further spread of COVID-19, audited companies may ask auditors not to perform observation of physical inventory counting.

When the observation of physical inventory counting is impracticable, the auditor is required to perform alternative audit procedures to obtain sufficient appropriate audit evidence on the existence and condition of inventory (ASCS 501, Paragraph 6). A careful deliberation will be necessary based on individual circumstances. The matter of general inconvenience to the auditors is not

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<sup>1</sup> Auditing standards generally accepted in Japan consist of Auditing Standards codified by the Business Accounting Council (BAC), and Auditing Standards Committee Statements (ASCSs) and a Quality Control Standard Committee Statement (QCSCS) issued by the Japanese Institute of Certified Public Accountants (JICPA). The ASCSs and a QCSCS are developed based on Auditing Standards codified by the BAC, and to converge with the International Standards of Auditing (ISA) and the International Standard on Quality Control 1 (ISQC 1) issued by the International Auditing and Assurance Standards Board (IAASB)."

sufficient to support the decision by the auditor that attendance is impracticable (ASCS 501, Paragraph A12).

In some cases where auditors' 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 the inventory (ASCS 501, Paragraph A13).

Obtaining confirmations from the third party for inventories under their custody and control may be adequate audit procedure for sufficient appropriate audit evidence.

(ASCS 501, Paragraph 7).

#### When alternative audit procedures cannot be performed

When the auditor is unable to perform alternative audit procedures or is unable to obtain sufficient appropriate audit evidence through those procedures, the auditor shall evaluate effect on the opinion in the independent auditor's report, in accordance with Auditing Standards Committee Statement 705 "Modification to the Opinion in the Independent Auditor's Report" (ASCS 705, Paragraph 5 (2)).

#### **(2) External Confirmation**

As a result of implementing preventive measures to avoid further spread of COVID-19, it is expected that auditors may not be able to obtain confirmations from financial institutions and companies located overseas because of the suspension of business operations or corresponding delays.

In the case of each non-response, the auditor would obtain information on the reason why each response cannot be obtained or on the situation of the other party and perform appropriate alternative procedures (ASCS 505 "External Confirmations," Paragraph 11).

#### When the auditor obtains substitute evidence

For example, with regard to accounts receivable, when responses to confirmation requests cannot be obtained as formal documents but when copies of confirmation replies are obtained through electronic means such as e-mail and used as a substitute, the auditor evaluates the substitute confirmation response for its reliability as audit evidence. In such a situation, based on the

situation of the confirming party, it will be necessary to evaluate the existence and the recoverability of accounts receivable. Based on the result of this evaluation, the auditor should determine whether it is necessary to change the audit procedures or perform additional procedures to eliminate doubts about the reliability of the information used. For example, the auditor may telephone the confirming party and determine whether the confirming party did, in fact, send the response (ASCS 505, Paragraphs 9, A12, and A14).

#### When substitute evidence cannot be obtained

When the auditor is unable to perform alternative audit procedures or is unable to obtain sufficient appropriate audit evidence through those procedures, the auditor shall evaluate effect on the opinion in the independent auditor's report, in accordance with Auditing Standards Committee Statement 705 "Modification to the Opinion in the Independent Auditor's Report" (ASCS 705, Paragraph 5 (2)).

### **(3) Reliability of audit evidence**

The auditor is required to consider the appropriateness and reliability of the evidence provided. (ASCS 500 "Audit Evidence," Paragraph 6).

#### When on-site visits to audited companies are restricted and audit evidence is obtained indirectly such as through electronic media

When on-site visits to audited companies are restricted, the auditor may use evidenced documents copied or converted into PDF or other electronic media by audited companies as audit evidence, and/or information downloaded by audited companies from their databases. In such situations, consideration should be given to the possibility of information being altered before providing to the auditor in the process of converting originals into electronic media or in processing data for downloading from the databases of audited companies.

Audit evidence provided by photocopies or facsimiles, or documents that have been transformed into electric form is less reliable than audit evidence provided by original documents (ASCS 500, Paragraph A31). This does not mean, however, that further audit evidence is required inevitably. The auditor should deliberately evaluate audit evidence altogether that has been obtained as to whether it is sufficient and appropriate to reduce the risk of material misstatements to an acceptably low level. When determined to be necessary,

through such evaluation, the auditor performs procedures to obtain additional audit evidence (ASCS 500, Paragraphs 5 and A6). Information provided as originals generally are more appropriate in terms of reliability than audit evidence provided as documents converted into electronic media. Thus, when documents transformed into electronic form are used as audit evidence, consideration should be given that the auditor needs to evaluate the internal controls over their preparation and maintenance. (ASCS 500, Paragraph A31).

#### **(4) Group audit**

When there are restrictions on the component corporate activities or on the work of the component auditors through the influence of measures to prevent the further spread of COVID-19, the group audit team will need to communicate more closely with the audited company and the component auditors. Consideration should be given to the following matters so the requirements of ASCS 600 “Group Audits” are satisfied.

- (a) Understand the nature and extent of the impact on each component. There will be cases where the group auditor may need to communicate with group management team regarding the impact on the component’s business and the method and timing for collecting necessary information to prepare group financial statements.
- (b) Understand the impact on the work performed by the component auditors. The group auditor should communicate with the component auditors regarding the impact on performing audit procedures and whether sufficient appropriate audit evidence could be obtained. There may be cases where instructions are sent to the component auditors with revised requested matters and the revised audit schedule.

The group auditor shall evaluate the effect on the group audit opinion in instances where there has been an inability to obtain sufficient appropriate audit evidence (ASCS 600, Paragraph 44).

## **2. Audits of companies whose fiscal year-end have already passed**

For companies whose fiscal year-end have already passed at the time of issuance of this note, they may need to carefully consider the impact of a

reduction or suspension of business activities, the material negative impact of, and the prospect for a downside risk of future cash flow and/or taxable income due to the spread of COVID-19, and determine whether these effects should be accounted for in the fiscal year being audited or in the following fiscal year. In such a situation, the impact due to the spread of COVID-19 as of the fiscal year-end and their extent should be estimated, and, in view of the extent of the impact, consideration should be given whether to reflect this impact in the accounting for the current fiscal year.

When these impacts are accounted for in the following fiscal year, consideration should be given, depending on the materiality of the impact, to determine whether or not to treat this as a note disclosed in the financial statements as a subsequent event of the current fiscal year (ASCS 560 “Subsequent Events” and Auditing and Assurance Practice Committee Statement 76 “Audit Treatment of Subsequent Events”).

### **3. Audit of internal control over financial reporting**

For listed companies, the impact on internal control audits should also be considered. In the internal control audits, when business sites within the scope of management assessment are located in regions where business activities are greatly influenced by the actions for the preventive measures to avoid the spread of COVID-19, the following matters should be considered.

When assessment procedures of management cannot be executed, this would correspond to restrictions on the scope of assessment from disasters or unavoidable circumstances, and the response taken can follow the treatment applicable to such circumstances (“Practice Standards for Management Assessment and Audit concerning Internal Control Over Financial Reporting,” II 3 (6) Restrictions of the Scope of Assessment). In such a situation, management, after understanding the impact of said facts, can exclude the said scope and express the results of the assessment of internal controls over financial reporting. The auditor can consider the description of the internal control report and the scope of the impact of being unable to assess internal controls due to unavoidable circumstances and expresses the opinions on the internal control in the independent auditor’s report on internal control assessment.

That is to say, when the auditor can confirm that (1) the assessment by management was executed appropriately overall except for unavoidable

circumstances and that (2) unavoidable circumstances preventing the execution of sufficient assessment procedures does not go so far as to have a material effect on the reliability of financial reports, the auditor can express an unqualified opinion on the internal control with additional information on the scope and reasons for management being unable to perform sufficient assessment procedures (“Practice Standards for Management Assessment and Audit concerning Internal Control Over Financial Reporting,” III 5 (2)). Accordingly, the auditor should examine the situation of the audited company sufficiently and should respond appropriately based on the possibility to perform necessary audit procedures.

#### **4. Extension of audit Schedule, etc.**

It should be noted that depending on the progress of audit procedures, the audit schedule needs to be revised as well as the submission date of the independent auditors’ reports. It is also necessary to pay attention to the account closing schedule of the audited companies.

#### Schedule Based on the Financial Instruments and Exchange Act

With respect to the Financial Instruments and Exchange Act, when annual securities and other reports cannot be submitted by their deadlines due to the inability to continue audit work related to Chinese subsidiaries or due to other unavoidable reasons from the impact of COVID-19, submission deadlines can be extended with the approval of the Director-General of the Local Finance Bureau or the Director-General of the Local Finance Branch Bureau ([“Notice regarding the deadline for submission of annual securities and other reports in connection with the COVID-19 \(Novel Coronavirus\) infection,” provisional translation published on March 13, 2020, Japanese version published on February 10, 2020](#)).

In addition, the Tokyo Stock Exchange, in light of the impact of COVID-19, has announced an overview of policies regarding timely disclosure, delisting, and listing examinations ([“Response to the Spread of Coronavirus \(COVID-19\),” March 18, 2020](#)).

#### Schedule Based on the Companies Act

With respect to the Companies Act, the Ministry of Justice has published explanatory materials on the timing for holding annual general meetings of

shareholders ([“On the Holding of Annual General Meetings of Shareholders” \[Japanese document\], published on February 28, 2020, revised on March 13, 2020](#)). There will be a need to examine specific responses together with the legal specialists of audited companies.