Disrupted Supply Chains And Other New Issues In Financial Statement Audits During COVID-19

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I. Disrupted Supply Chains, Purchasing Bubbles, Inflation, And Other Altered Economic Conditions.

Several global economic developments could be observed in 2021, which may have translated into the way that audited businesses operate and, consequently, may have been reflected in their 2021 financial statements.

An important phenomenon that may have affected the performance of operators (and consequently be reflected in the risks of an audit) was the disruption to supply chains[1] that resulted in the creation of so-called purchasing bubbles[2]. Patrick Burnson, describing the EventWatch Report[3], reveals that disruption related to supply chain issues had already increased by 36% in 2018. The problems associated with supply chains then escalated after the outbreak of the Covid-19 pandemic. In the McKinsey & Company article entitled "How COVID-19 is reshaping supply chains"[4], the authors indicated that as a result of problems with supply chains, companies chose to increase inventories of critical products as a key strategy (61% of surveyed companies). 55% of companies chose dual sourcing of raw materials, and 42% began increasing inventory along the supply chain. The same McKinsey & Company survey revealed that “Almost 90 percent of respondents told us that they expect to pursue some degree of regionalization during the next three years.”

As preparations for the 2021 audit continue, it is worth highlighting the new economic issues that may affect the 2022 audit.

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[1]The term "supply chain" should be understood as all the operations associated with the sourcing of raw materials, transport and production or processing of goods, and finally the delivery of a product to consumers.
[2]The term "purchasing bubble" refers to a purchasing spiral that, fuelled by unsustainable demand for end products and through lack of availability of raw materials or goods, results in parallel purchasing (for stock) from different suppliers simultaneously.
[3]Burnson, P. 2019. Global supply chain risk events increased 36% in 2018 according to resilinc’s annual EventWatch. Accessed February 20, 2022. https://www.scmr.com/article/global_supply_chain_risk_events_increased_36_in_2018_according_to_resilincs
[4] Knut Alicke, Ed Barriball, and Vera Trautwein 2021, How COVID-19 is reshaping supply chains. Accessed February 20, 2022, https://www.mckinsey.com/business-functions/operations/our-insights/how-covid-19-is-reshaping-supply-chains

Until now, economic actors have often operated based on distributed production models (components were produced or assembled where costs were lower) using transport between production and assembly facilities.

For example, there are few highly specialised companies producing relatively small and high-tech components for the global market (e.g., chips, bicycle components). The disruption of supply chains and the global obstruction of transport from these companies resulted in final product production downtimes of several months (e.g., cars, radiators, bicycles) in the target markets, including Poland.

Products ordered in remote locations due to low production costs are another example. Companies usually ordered large quantities of such products in one go to allocate shipping costs. Should this be the case, the disruption of supply chains could block the purchase of such large batches for several months and lead to the need to purchase again from local suppliers. This has, therefore, had a significant impact on warehouse inventories (creating a purchasing bubble and buying for stock) and the need to employ additional warehouse staff (increased remuneration for these people).

Transport problems, e.g., blocked ports of transhipment that cannot be cleared for up to several months, have also become an important issue for consideration in relation to disrupted supply chains. This problem may significantly affect the risk associated with the identification of stocks and their value.

The need to find new suppliers has led to local market demand for producers of the products described above. This could have led to end product re-engineering (existing substitutes had different parameters), use of quality-unproven components (increased risk of complaints and reduction of brand value by using components of unknown quality), increased burden on logistics staff (increased demand for staff in this area, resulting in pressure on wages), creation of in-house component production departments (increased investment expenditure – risk of over-investment), and other risks related to this issue.

As deliveries are delayed considerably at the production sites alone, there may be temporary downtimes. Consequently, the risk arises that an operator will also allocate costs of idle capacity in the stock value.

In addition to production problems, long-term contracts may also be an issue. Failure to deliver may result in blocked deliveries and high contractual penalties. Such a risk should be particularly closely examined when the financial statements are audited as the amounts of such penalties are often substantial. A change in the profitability evaluation of a given contract may also be relevant due to increased costs and inflation alike.

The result of such a long delivery time of the components in question may be that the stocks produced from them are out-of-date both physically (e.g., use of perishables after their expiry date or use of products that have deteriorated due to prolonged and inappropriate storage) and morally (e.g., there have been legal changes that require a different grade of solutions to be applied or there have been changes in fashion, design, trends, etc.). Such stocks, therefore, can be difficult to run down, both because of the commodity itself and because of changes in the market profile for consumption or investment.

In addition, there is the phenomenon of customers withdrawing from purchase plans for high-value goods (e.g., cars) due to significant (supra-contractual) delivery lead times. In such cases, it may also be necessary to make provisions for contractual penalties.

With the need for increased procurement and costs, producers will be forced to find ways to cover working capital demands. This may result in increased issue of debt instruments (e.g., bonds or investment notes) or increased demand for credits. Particular attention should, therefore, be paid to such aspects of an operator's operations during the audit.

Additionally, attention should also be paid to increased interest rates (an increase in the central bank's reference rates). These can translate into an inability to repay the credits taken out and contribute to a debt spiral.

The above illustrative risks may be reflected in the following elements of the financial statements:

a) Stocks (especially risks of overvaluation of stocks, expiry, changes in demand as well as risks related to contractual penalties due to withdrawal from contracts, the risk of "burning warehouses" - i.e., the existence of material events after the balance sheet date)
b) Futures contracts (risks associated with inflation and increased costs, profitability evaluation changes, pricing as well as risks associated with contractual penalties for prolonged delivery)
c) Financial instruments (risk of solvency, lack of collateral coverage, and risk of misuse of funds)
d) Provisions (no corresponding provision for contractual penalties presented)
e) Liabilities (incorrect valuation of liabilities, failure to properly present collateral)
f) Intangible assets (e.g., the valuation of trademarks may change due to altered positioning of a brand)
g) Costs (increased payroll costs, increased warehousing costs, increased downtime and, therefore, increased idle capacity, significant exchange rate differences)

The above list is only an example of the possible risks and their impact on the financial statements. A separate approach for each company is required from an auditor.

II. Customer Identification

Based on the brief analysis of the disrupted supply chain issue above, when auditing the 2021 financial statements, audit teams should thoroughly reanalyse the customer and what changes have taken place in the way the customer operates. The auditor should not rely solely on the previous knowledge but should reconsider and thoroughly identify the socio-economic environment of the company and changes in supply chains. In this respect, the guidelines of the International Standard on Audits IFAC 315 should be followed.

III. Fraud Risk

When approaching the analysis from the perspective of the fraud risk triangle[5] it is important to consider:

- Pressure – employees and managers may experience greater pressure to commit fraud, related to the potential deterioration of the financial condition of an operator and increased stocks.
- Opportunity – intense pressure to purchase may lead to stocks being inadequately secured or overvalued and thus to a temptation to destroy assets to claim insurance recoveries; in addition, managers can improve the financial result through a number of stipulations (which may include failure to set provisions, or failure to write off idle capacity).

[5]Based on D.R. Cressey's Theory of Fraud

- Rationalisation - employees and managers may rationalise fraudulent conduct by thinking: "this is essential to help the company survive, and no one will get hurt."

When planning an audit, audit teams should consider any potential fraud risks that could have a material impact on the financial statements. They should understand the measures undertaken by management to mitigate these risks and then assess whether the audit procedures they have planned need to change. In this respect, the guidance of IFAC 240 International Standard on Audits should be followed.

IV. Auditing Estimates

Given the highly fluctuating patterns of the economy, this area of audit will pose a significant challenge for the auditors. In the current year, the International Standard on Audits IFAC 540, which places a special emphasis on risk analysis, applies to the auditing estimates.

In light of the above analyses, write-downs, provisions, valuation of a company, valuation of intangible assets can be listed as specific risk areas among other elements.

It should be indicated that in the current period it is difficult to use analyses prepared based on historical figures. It may be necessary to use experts to conduct a valuation of individual assets throughout the current season.

V. High Relevance Of Consultations

As the ongoing pandemic may have affected the shape of the financial statements in unexpected ways, key auditors may find it difficult to interpret these statements. In such cases, consultation with other auditors or experts becomes indispensable.

It is important to note that the changed business environment can lead to extremely negative phenomena linked to fraudulent accounting or even to the creation of so-called pyramid schemes.

To sum up, the COVID-19 pandemic has a long-term effect on the economic reality and, therefore, on the way in which audits are performed. The new phenomena prevent the application of simple historical analyses and prompt a deeper insight into the new risks emerging in companies and, therefore, increased alertness during audit procedures.