

# **SAI Audit Considerations to the Impact of COVID 19 on the Extractive Industries Sector by Edmond B. Shoko, AFROSAI-E**

## **Introduction**

Through the literal works and publications of its various working groups and regional secretariats, the INTOSAI community has always been aware that disaster often strikes unannounced with insurmountably disruptive effects. With each disaster strike be it natural or manmade, the role of the Supreme Audit Institutions (SAIs) in the efforts of humankind to restore a semblance of order during these times has proven invaluable. The COVID19 pandemic is one such global disaster which has truly put to the test the disaster preparedness status of both the governments of the world and the private sector business in the extractive industries sector.

The extractive industries sector has always been regarded as a high contributor to government revenue and economic growth for many countries. It is an area where transparency and accountability are of paramount importance. Through the performance of various audits, the SAI is seen as a beacon of transparency and accountability of the proper governance of mineral resources for the benefit of current and future citizens of the country. Central to the events around COVID19 and its impact on the extractive industries sector, has been the question of the resilience of the SAIs in responding to various extractive industries stakeholder expectations in times of this pandemic. SAIs should continue to be an institution which brings in value and benefits to the citizens of its country.

It is widely accepted that the COVID19 pandemic is indeed one of a kind based on the magnitude of disruption it has brought about to the social, economic, and political construct of the way of life globally. The objective of this paper, is to establish a triage of areas within the extractive industries sector which have been affected by the COVID19 pandemic and propose audit considerations by SAIs in responding to the related audit risks.

Using doctrinal research methodology, the paper is divided into three sections. Post this introduction, the paper explores the main global events on how the extractive industries environment reacted to the the COVID19 pandemic. From this exploration, the paper identifies the major reactions by key stakeholders in the extractive industries sector to the COVID19 pandemic and goes on to interrogate their impact on the extractive industries environment. The second section of this paper attempts to map and link the identified major reactions to a triage of key audit risk areas within the extractive industries sector. The identified triage of risk areas is then complimented by proposed SAI auditor audit considerations. The last section of the paper gives conclusions and recommendations to SAI auditors on the findings of this research.

## **COVID 19 and the extractive industries sector**

In response to the pandemic, governments around the world adopted sweeping measures, including full lockdowns, shutting down airports, imposing travel restrictions and

completely sealing their borders, to contain the virus.<sup>1</sup> The COVID-19 pandemic has affected the global commodity markets in a variety of ways that have challenged the extractive industries sector. Company operations have been affected through isolated outbreaks and government mandated shutdowns and the demand for many commodities remained low with a lower near-term demand on the horizon for the greater part of the year 2020.<sup>2</sup> Whilst the overall socio-economic impact of the pandemic on the extractive industries sector is not yet known, it can however be concluded that it will be felt for many years to come.

Several economies in the world especially in Africa are sustained by the extractive industries sector. The majority of these countries' national budgets are dependent on mining, oil and gas exports. To date, the survival of these economies is, largely dependant on how the extractive industries are regulated during the fight against the pandemic. To this end, it is noted that special dispensations have been given to the operations of the mining sector in several African countries despite imposed nation-wide lockdowns. For instance, South Africa allowed the reopening of mining operations under 'Level 3' lockdown regulations permitting mining companies to operate fully.<sup>3</sup> Whilst Zimbabwe and Namibia<sup>4</sup> allowed their mining and diamond sectors respectively to operate as essential services.<sup>5</sup> In the most extreme of cases, countries such as Mozambique, Angola, Zambia and the Democratic Republic of Congo did not completely shut down mines, but some mining companies voluntarily decided to reduce their activities. This is indicative of the paramount importance of the extractive industries to the state machinery. As such SAIs have a role to play in ensuring transparency and accountability of government activities in this sector is upheld during this disaster period.

The effects of COVID19 can be classified into four major reactions by the operating environment of the extractive industries sector: (1) Unprecedented fluctuations in commodity prices, (2) Suspension of projects, lowering production and "shut-ins" decisions, (3) Investor exploration and development budget cuts, and (4) Government delays in global oil and gas licensing rounds. Below is an account of these ways and their impacts.

#### (1) Unprecedented fluctuations in commodity prices

Within this environment, commodity prices have fluctuated significantly. Between April and May 2020, oil prices hit two very different first-of-its kind milestones. In April West Texas Intermediate (WTI), the U.S. oil benchmark, plunged below zero and into negative territory for the first time on record.<sup>6</sup> When the month of May came, oil prices shaped up to be WTI's best month ever, going back to the contract's inception in 1983, an astonishing turnaround

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<sup>1</sup> Aljazeera "Coronavirus: Travel restrictions, border shutdowns by country"

<https://www.aljazeera.com/news/2020/03/coronavirus-travel-restrictions-border-shutdowns-country-200318091505922.html>. Retrieved 4 April 2020.

<sup>2</sup> Deloitte 2020

<sup>3</sup><https://www.mining-technology.com/news/south-africa-plans-to-relax-lockdown-as-mines-re-open/>

<sup>4</sup> <http://namibianminingnews.com/diamond-producers-to-continue-operations-despite-covid-19-outbreak/>

<sup>5</sup> <https://m.fin24.com/Economy/zim-extends-lockdown-by-two-weeks-allows-mining-to-fully-resume-20200419->

<sup>6</sup> <https://www.cnbc.com/quotes/>

month-on-month.<sup>7</sup> As per figure 1, JP Morgan has a point forecast of \$190 in 2025 after they calculated a straight line from the then current price of \$38



Figure 1: Oil price fluctuations and forecasts (Source: RystadUCube, JP Morgan 2020)

## (2) Suspension of projects, lowering production and “shut-ins” decisions

Possibly with the strategic intention to expand storage capacity and trying to market their crude oil and mineral output with the best sales and purchase agreements and financial hedging instruments possible, several mining companies suspended<sup>8</sup> operations<sup>9</sup> during the pandemic. On the other hand, well shut-ins became “the new black” as most companies, especially in the U.S. shale patch, seemed to be shutting in wells in response to what is shaping up to be the Great Glut of 2020.<sup>10</sup> The suspension of projects, lowering of production and “shut-ins” have a way of creating uncertainty in the extractive industries due to its technical nature. At the time of these activities, there was no evidence on the likely effects of these decisions. To date the general impact of these activities was a loss in commercial production and a decline in fiscal hydrocarbon revenues for governments in 2020 as depicted in Figure 2 and 3.

<sup>7</sup> <https://www.cnbc.com/2020/05/25/oil-is-on-track-for-its-best-month-ever-after-rebound-but-traders-say-its-not-out-of-the-woods.html>

<sup>8</sup> Per A. Bauer (2020) - More than 268 mine suspensions so far, some of the largest mines include: Antamina (Peru, copper-zinc), Antofagasta (Chile, copper-gold), Cigar Lake (Canada, uranium), Cobra Panama (Panama, copper-gold), Kumba (South Africa, iron ore), Panasquito (Mexico, gold-silver), Mogalakwena and Impala (South Africa, palladium-platinum).

<sup>9</sup> <https://www.oilandgasvisionjobs.com/news-item/two-companies-suspend-production-at-some-sites-in-response-to-low-oil-price>

<sup>10</sup> <https://oilprice.com/Energy/General/The-Major-Problem-With-Shutting-Down-Oil-Wells.html>

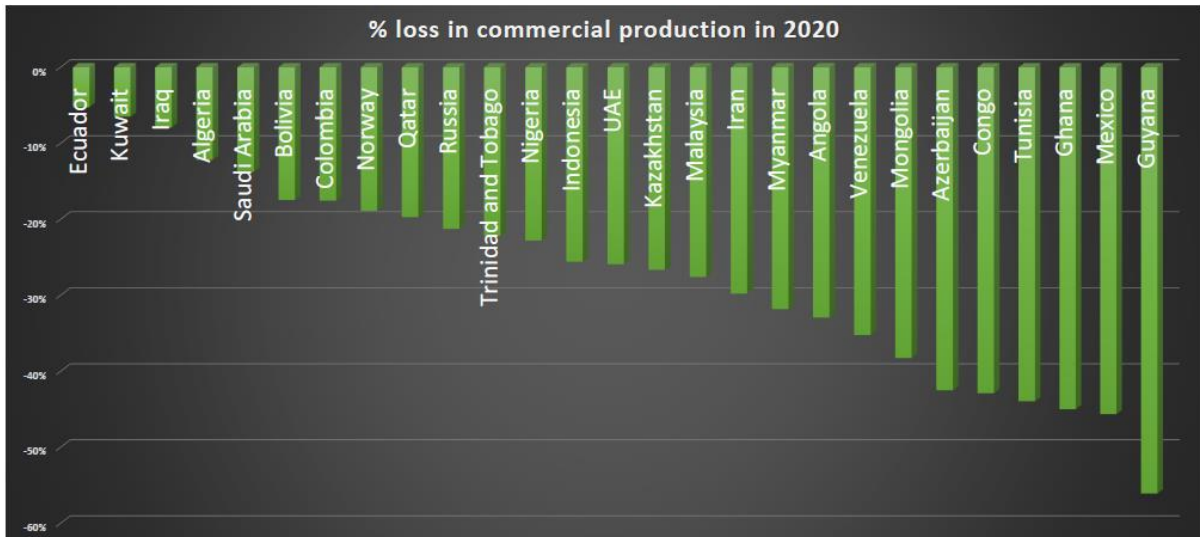


Figure 2: Sources: Rystadand NRGi

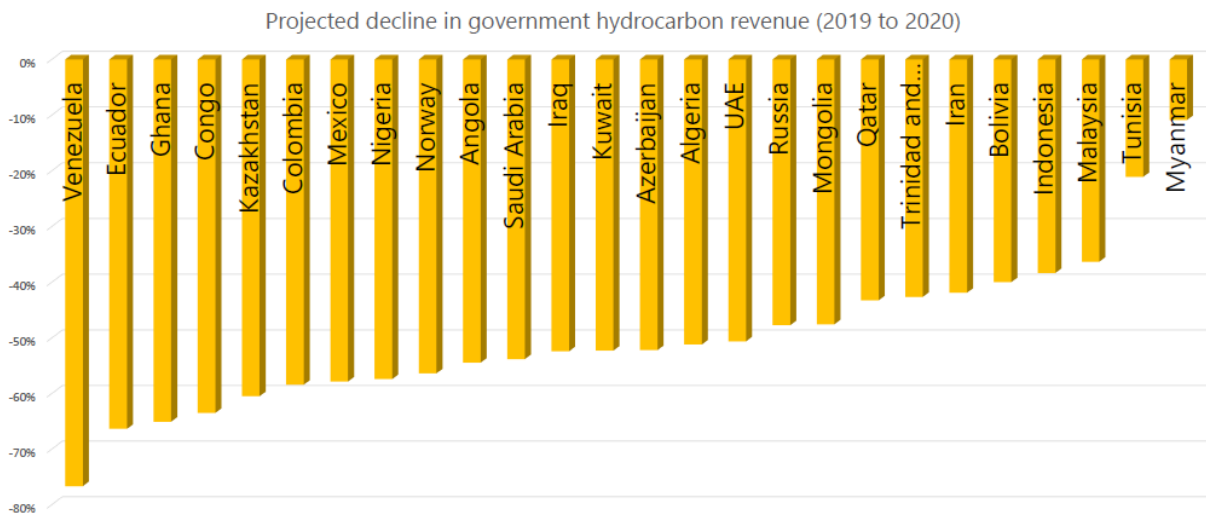


Figure 3: Sources: Rystadand NRGi

### (3) Investor exploration and development budget cuts

During such a volatile time, mining companies had to come up with strategies to ensure their survival in the long run. It was noted that in the wake of COVID19, mining companies reviewed their project development plans, whether they have already been launched or are still pending approval.<sup>11</sup> For example, extractive industries giants such as Eni and Total, the two international oil and gas majors with the largest presence in Africa, signalled 25% cuts to their investment in exploration and production projects in 2020. Such cuts work out to a €4bn reduction for the French giant and a \$2bn reduction for its Italian rival.<sup>12</sup> It can be concluded that the impact of these cuts has contributed to an increase in the Global mean production risk for several countries, see Figure 4.

<sup>11</sup> <https://www.theafricareport.com/27566/coronavirus-pandemic-puts-strain-30-major-african-oil-and-gas-projects/>

<sup>12</sup> Ibid

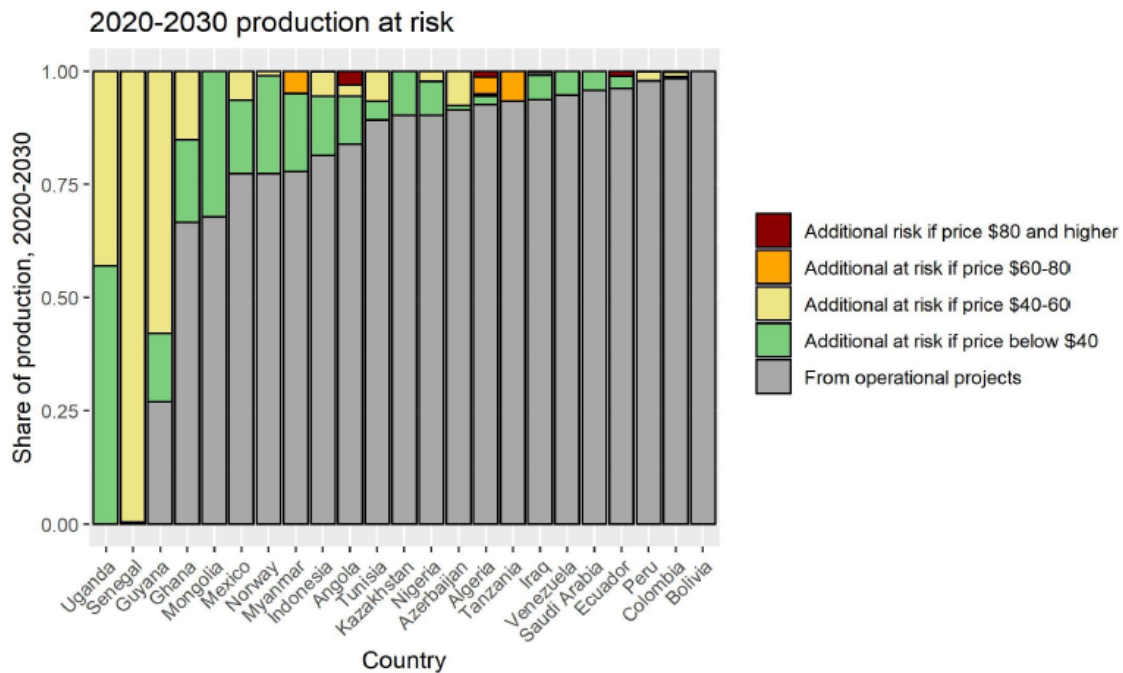


Figure 4: Source: RystadUCube, NRGi calculations (A.Bauer: Global mean production at risk is 14%, median is 10%).

#### (4) Government delays in global oil and gas licensing rounds

With oil and gas investors reluctant to commit an exploration budget to licensing rounds. Instinctively, this meant that licensing rounds that proceeded in the wake of the COVID19 pandemic risked receiving fewer or no bids. In response, several governments extended, delayed or temporarily suspended licensing rounds. This was an attempt to either prioritise managing the domestic impact of the virus or wait for investment conditions to improve. Bangladesh, Liberia and South Sudan were forced to announce changes to their proposed licensing rounds subsequently in 2020.<sup>13</sup> It is noted that the impact of these delays has been an increase in the Global mean production risk for several countries, see Figure 4.

#### Triage of Audit Risk Factors for SAIs to Consider

The effects of COVID19 on the extractive industries sector have been seen to be classified into four major reactions within the operating environment of this sector. These reactions in the operating environment have potentially created new audit risks and previous existing risks might have also been altered significantly for the SAI auditors. ISSAI 1315 deals with the auditor’s responsibility to identify and assess the risks of material misstatement in the financial statements, through understanding the entity and its environment, including the entity’s internal controls.<sup>14</sup> A preliminary review of these reactions identifies 4 key audit risk factor areas namely: (a) financial liquidity; (b) business operations; (c) Human capital and (d) the legal environment.<sup>15</sup>

<sup>13</sup> <https://www.offshore-technology.com/comment/covid-19-oil-gas-licensing-rounds/>

<sup>14</sup> ISSAI 1315 “Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment” Para 3.

<sup>15</sup> Ernst & Young “Transfer pricing impacts and responses” International Tax and Transaction Services global webcast. 2020.



Figure 5: The 4 Key audit risk factor areas associated with COVID19 Extractive Industries Sector environment reaction.

#	Key Risk Area & Description	SAI Auditor Considerations
1	<p><b>Financial Liquidity</b></p> <p>The COVID-19 pandemic has had a negative impact on MNEs access to funding and financing with consequences for transfer pricing of intercompany financial transactions</p>	<p>Due to the fundamental need to respond to liquidity crunch, auditees may have come up with forced short term and medium-term decisions to avoid haemorrhage. The auditor should consider obtaining an understanding on some of the following:</p> <ul style="list-style-type: none"> <li>• To what extent did auditees manage their short-term cash needs effectively,</li> <li>• To what extent did auditees manage the long-term financial impact of the COVID-19 crisis on their subsidiaries to continue (relatively) uninterrupted operations</li> <li>• With respect to the auditee, to what extent did the instability create a need for “quick” cash access</li> <li>• How has the credit risk profile of the auditee been affected and what is the expected impact on the credit rating in the near future.</li> <li>• To what extent are the auditee’s intragroup funding policy and cash pooling needs reflective of current crisis management</li> </ul>
2	<p><b>Business Operations</b></p> <p>The pandemic has resulted in several disruptions to the value chain and the implications of</p>	<p>The supply chain disruptions have had several notable negatives “route to market” impact. These include amongst others, disrupted consumer/customer patterns, Changes to customer</p>

#	Key Risk Area & Description	SAI Auditor Considerations
	<p>hitting “pause” in the supply chain of the extractive industries sector.</p>	<p>terms and conditions that impact the downstream value chain and Access to markets and export restrictions on ‘essential’ goods and materials. The auditor should consider:</p> <ul style="list-style-type: none"> <li>• Assessing whether the auditee’s risk management function is changing</li> <li>• understanding the extent to which auditee’s local / regional management is being empowered by necessity for crisis management</li> <li>• Identifying which supply chain processes are being de-centralized due to crisis response</li> <li>• Assess the extent to which changes to supply chain are temporary or permanent.</li> <li>• Quantifying extraordinary costs in the supply chain due to disruption, and identifying where those costs are being borne as compared to where they are being managed</li> </ul>
3	<p><b>Human Capital</b> The alignment of risk management functionality and current transfer pricing policy as a crystallization of risk due to COVID-19.</p>	<p>Several areas of human capital impact have been noted for various auditees. These range from stranded or impacted executives and forced relocation of key organisational decision makers to remote working to Pressure on traditional governance models. The SAI auditors may consider the following:</p> <ul style="list-style-type: none"> <li>• Re-performing an assessment of the value chain analysis on changes in significant people functions, relevance and responsibilities</li> <li>• Obtaining an understanding on what flexible working arrangements should be and have been put in place by the auditee</li> <li>• Obtaining an understating as to what extent new location of significant people functions (remote working etc.) imply reviewing and assessing other risks (e.g., permanent establishment (PE))</li> <li>• With regards to idle workforce and work-sharing – auditors should consider</li> </ul>

#	Key Risk Area & Description	SAI Auditor Considerations
		identifying what incentives and credits local governments are providing.
4	<p><b>Legal Environment</b> Several legal grounds to challenge or amend investor state contractual arrangements have been created by the pandemic situation. These include amongst others:</p> <ul style="list-style-type: none"> <li>• Terms and conditions</li> <li>• Force Majeure</li> <li>• Unforeseen circumstances / material adverse change</li> <li>• Reasonableness and fairness</li> <li>• Voluntary actions / renegotiations</li> </ul>	<p>Several contractual clause items are vulnerable such as Pricing / payment terms; Cash flow matters; Production; Delivery; Demand / volume and Exchange rates.</p> <p>Auditors need to consider:</p> <ul style="list-style-type: none"> <li>• Assessing whether 3rd party agreements serve as real life benchmarks.</li> <li>• Analysing the agreements considering the new operational reality.</li> <li>• Determining legal justification of amending agreements</li> <li>• Documenting the analysis and the reasoning behind the amended agreements.</li> </ul>

### Conclusion and recommendations

The objective of this paper, was to establish a triage of areas within the extractive industries sector which have been affected by the COVID19 pandemic and propose audit considerations by SAIs in responding to the related key audit risk areas. While the COVID-19 disaster has exposed several vulnerabilities of the extractive industries sector, these vulnerabilities also extend to how the SAIs need to consider their audit approaches and related risk assessment during this disaster period. From the analysis performed, the following conclusions and recommendations have been made:

- The effects of COVID19 can be classified into four major reactions by the operating environment of the extractive industries sector. To these, there are also four key risk areas which auditors need to consider in order to perform quality audits.
- SAI auditors are recommended to make considerations against the triage of four key risk areas identified as a starting point to their risk assessment and move on to strategically think of other ways in which the auditee’s responses to the four identified major crisis reactions could have affected the auditee’s audit risk profile.
- The timing of the performance and the nature of audit procedures is of essence under a state of disaster. Due to the high risk and fast paced nature of how transactions tend to occur under a disaster situation, in order to effectively offer audit services which



are beneficial to the extractive industries sector, the paper proposes two timings (a) Real time audit<sup>16</sup> and (b) End of year audit.

- The extent of audit procedures performed is to be determined by the audit risk appetite of the SAI in relation to the risk being responded to and the level of assurance the SAI intends to provide to the users.

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<sup>16</sup> The paper defines "Realtime audit" as the "continuous" aspect of constant auditing and reporting refers to the real-time or near real-time capability for financial information to be checked and shared. Not only does it indicate that the integrity of information can be evaluated at any given point of time, it also means that the information is able to be verified constantly for errors, fraud, and inefficiencies