



Research Report

Key Audit Matters

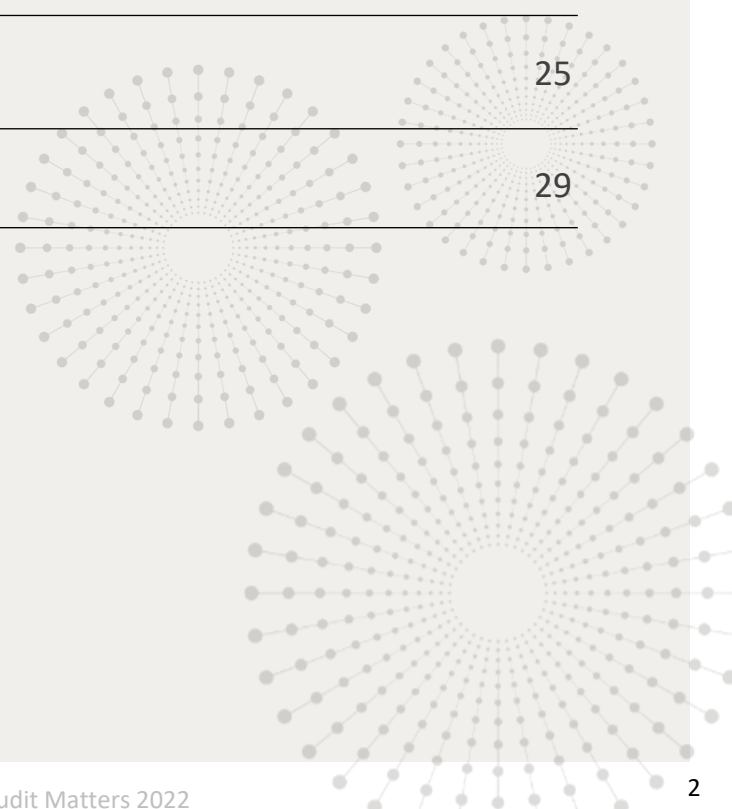
Understanding the communicative value
and readability of audit reports

2022

Contents



Foreword	3
Scope	4
Key findings	5
Key audit matters (KAMs) reporting	6
KAM communications over time	9
Understandability	15
Voluntary reporting	20
Non-standard reports	23
Special topics	25
Appendix A: Sample overview	29



Foreword

We commissioned the University of Auckland to undertake research into reporting practices for key audit matters (KAMs) to assess how the standard is being applied since it was first introduced in 2017.

Commissioning this work is also driven by a need to understand the overall communicative value of KAM reports. Specifically, whether they can be easily understood and to what extent 'boilerplate language' is used. We also know that users find KAMs more useful when they are specific to the entity, so the ability to assess to what degree KAMs are entity specific or more generic is also valuable. Lastly, given the impact of COVID -19, we wanted to be able to have sight of what effect it has had on KAMs.

We recognise auditors face a number of challenges when describing KAMs. Using concise but informative and accurate language is one such challenge. Avoiding standardised wording and keeping KAMs evolving when in many instances the same KAMs will arise each year is another problem auditors face.

While the research does identify instances of repeated content, a balance of comparability and entity-specificity in the KAMs is evident. It is also worth noting that some repetition would be expected given many key risk areas are consistent year on year.

However, the research also found that roughly half of the reports contained KAMs that may not be easily understood by all users. We recognise that KAMs are often about the most complex areas within financial statements, and frequently link directly to content in the financial statements, but we encourage auditors to continue to explore ways to enhance the communicative value and understandability of KAMs.

We will continue our work to influence international standard setters as the debate on the future of audit continues. The International Auditing and Assurance Standards Board (IAASB) is currently exploring the auditor's responsibility in the financial statement audit - specifically with respect to fraud and going concern and we are closely monitoring the IAASB's thinking and direction in this area. Should they decide to add more information into the auditor's report, we will be interested to see what impact these will have on the communicative value and understandability of the auditor's report.

April Mackenzie

Chief Executive



Key Audit Matters

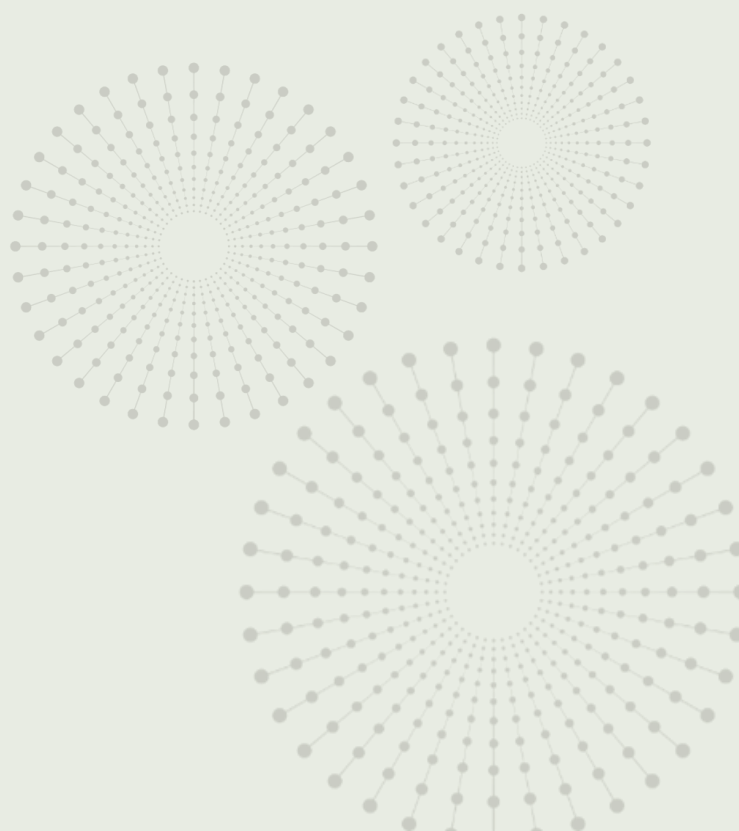
Research Report

Research scope

The Research reviewed and analysed 470 audit reports of 235 entities over the period 2020 to 2021. The sample included 127 NZX listed entities, 72 non-listed entities in the banking, insurance, and financial services sector, 10 issuers of debt securities, 4 derivative issuers, and 22 other non-listed entities that are required to comply with the enhanced reporting requirements. Appendix A provides a more detailed overview of the sample.

Author

Dr Lina Li
Business School
University of Auckland



Key findings

Number and Type of KAMs

The number and types of KAMs reported have stayed relatively stable and on average, each audit report contained two KAMs. While the average number of KAMs is similar across different entity types, the most frequently reported KAM type, varied by sector.

There was a high level of 'stickiness' in the KAMs reported with on average, 84% of KAMs reported in 2021 being repeated from 2020. In other words, the majority of KAMs reported for each entity tend to be recurring.

Are KAMs generic or entity specific?

There was on average 66% repeated textual content in recurring KAMs reported. Interestingly, there was less repeated content for listed entities than for non-listed entities. The average level of textual similarity in KAM narratives was around 50%. Overall, although there was some repeated content in the KAMs disclosed year-to-year and relative to peer entities, there was a balance of comparability and entity-specificness in the KAMs reported.

Topics

The frequency of use of Emphasis of matter (EOM) paragraphs increased in 2020 and 2021 compared to prior periods. These were focused on uncertainties brought about by Covid, which to some extent explains the higher number of EOMs.

A high proportion of audit reports contained discussions of Covid in the KAMs disclosed (60% in 2020, 39% in 2021). Valuations of assets, including PPE, intangibles, goodwill and other assets were most impacted.

There was a low level of reporting on climate-related issues.

The frequency of material uncertainty related to going concern (MURGC) and going concern KAMs reported in 2020 and 2021 was comparable to those reported in prior periods.

Length and ease of reading

A Flesch reading-ease index analysis revealed that KAMs in 98% of the audit reports were very difficult to read. About half of the reports contained KAMs that are best understood by professionals or readers with advanced university degrees. These KAMs may not be easily understandable by all users of the audit report.

Key audit matters (KAMs) reporting

KAMs provide transparency about the matters that, in the auditor’s professional judgement, were of most significance in the audit of the financial statements. KAMs are selected by the auditor from the matters communicated with those charged with governance. When selecting KAMs to report, the auditor considers: areas with a higher risk of material misstatement, significant auditor judgements relating to areas in the financial statements that involved significant management judgements, and the effect on the audit of significant events or transactions that occurred during the period. KAMs often cover areas where the most audit effort was expended.

The following provides an overview of the frequency and types of KAMs for entities in our sample (refer to appendix).

Number of KAMs

The median (mean) total number of KAMs reported within our sample period was 2 (1.76). As shown in Figure 1a, most entities had one or two KAMs. The average number of KAMs reported has remained stable since the introduction of KAM reporting in 2016. In 2021, twelve percent of the sample had three KAMs, and less than 5 percent of the sample had four or more KAMs. In 2020, the proportion of entities with four or more KAMs was slightly higher. Overall, the distribution of the number of KAMs in 2020 and 2021 was comparable.

Figure 1a: Distribution of KAMs number

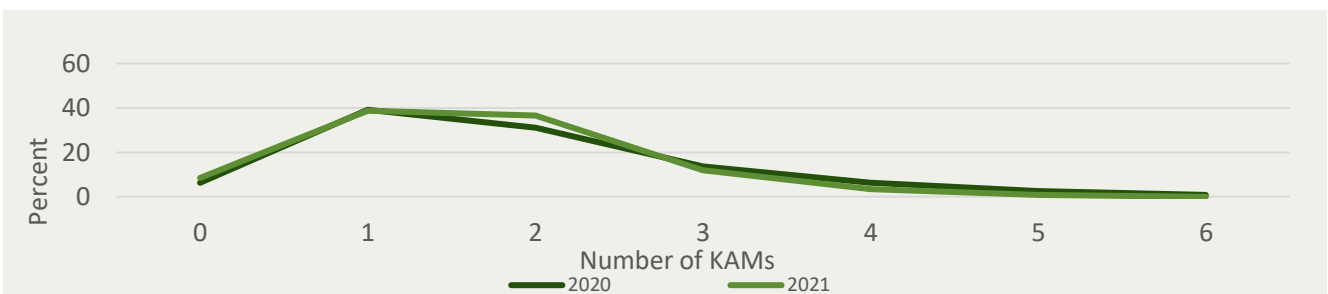


Figure 1b shows the median and maximum number of KAMs reported for each entity type. The average number of KAMs was similar across the entity types (median being one or two KAMs). Listed entities and non-listed banks had the highest number of KAMs reported (six KAMs), whereas entities with a lower profile, such as property schemes and forestry schemes, had one KAM as the maximum number reported.

Figure 1b: Number of KAMs by entity type

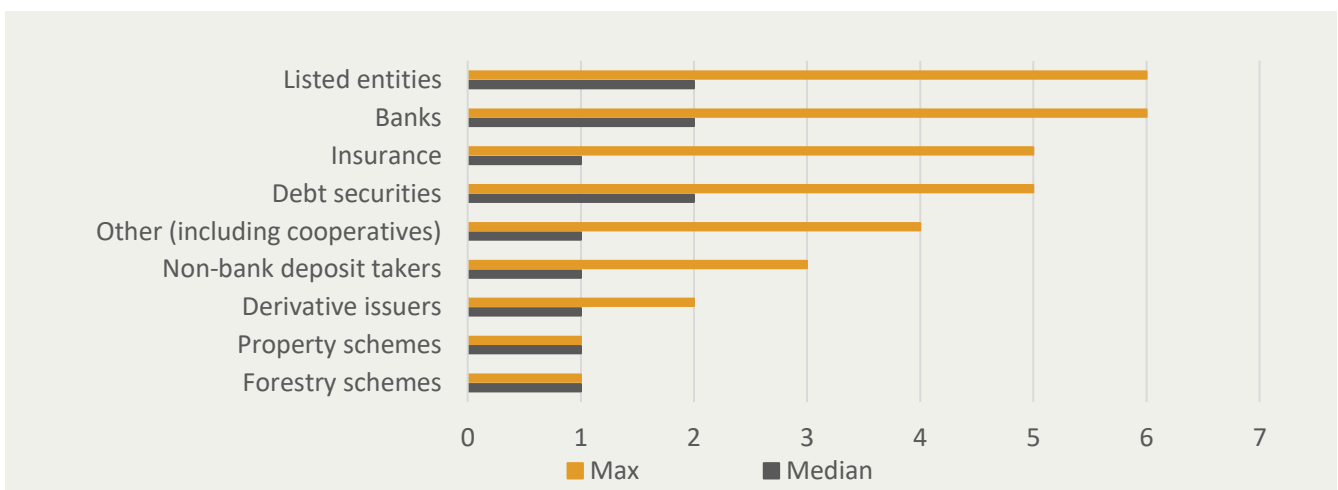
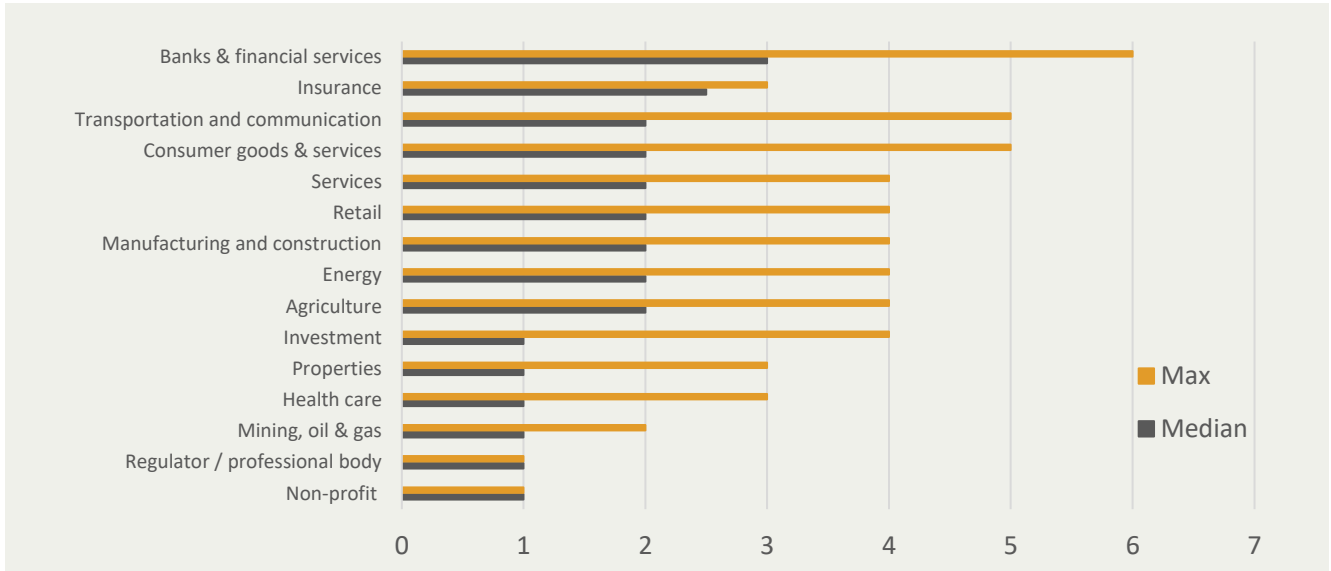


Figure 1c shows the number of KAMs for listed entities by industry sector. Banking and financial services sector had the highest number of KAMs on average, reflecting the complexity of the audit of the financial sector. The insurance sector had a slightly higher median (2.5) than the rest of the industries, which had one to two KAMs on average.

Figure 1c: Number of KAMs by industry



KAM types

Figure 2 shows the distribution of KAM topics. A total of 437 (389) KAMs were reported in 2020 (2021). The most common KAM type related to impairment and valuation of goodwill and intangible assets, making up 13% (15%) of the total KAMs reported in 2020 (2021). Valuation of property, plant and equipment (PPE) was the second most common KAM type, with about 14% of the KAMs falling in this category in both years. Other KAM types included measurement of provision/allowance, revenue recognition, accounting for business combinations (such as acquisitions, investments in joint ventures, etc.), and accounting for leases. The KAM types reported were broadly consistent with findings from the previous joint XRB and FMA research.

Figure 2: KAM topics

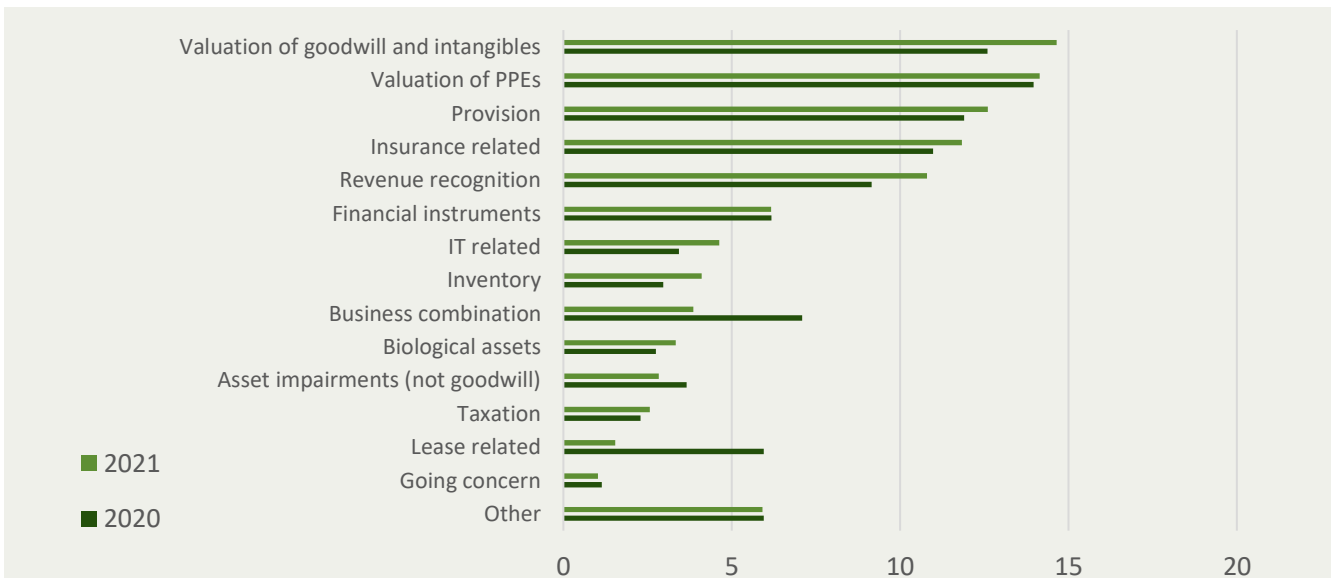


Table 1a shows the most common KAM types for each entity type. Banks and non-bank financial service providers commonly had provision and IT related KAMs. Valuation of goodwill and intangible asset, and PPE valuation were the most common for listed entities. Insurance-related KAMs were the most common for entities in the insurance sector. Certain entities had a specific KAM type reported, e.g., valuation of PPE for property schemes and valuation of biological assets for forestry schemes. Overall, the KAMs identified by the auditors were specific to the nature of the entity's business.

Table 1a: Common KAMs by entity type

	Most common KAM	Percent	2 nd Most common KAM	Percent
Banks	Provision	56.86	IT related	29.41
Non-bank deposit takers	Provision	68.09	IT related	14.89
Insurance	Insurance related	71.31	Provision	8.20
Listed entities	Goodwill and intangible assets	20.6	Valuation of PPE	14.6
Debt securities	Valuation of PPE	54.76	Business combination	14.29
Derivative issuers	Revenue recognition	75	Lease related	12.5
Others (incl. co-operatives)	Revenue recognition	29.55	Valuation of PPE	13.64
Property schemes	Valuation of PPE	100		
Forestry schemes	Biological assets	100		

Table 1b shows the most common KAM types for listed entities by industry. Goodwill and intangible assets related KAMs were the most common for many industries, including consumer goods & services, health care, manufacturing and construction, services, and regulator/professional body. Valuation of PPE was the most frequently reported KAM type for the following sectors: energy, properties, and transportation and communication. Entities in the agriculture sector had biological assets as the most common KAM type. Similar to non-listed banks and financial institutions, listed banks and financial services providers also most frequently received provision and IT related KAMs. Overall, these patterns in the KAM types reported for each industry are largely consistent with findings from the previous joint XRB and FMA research findings.

Table 1b: Common KAMs for listed entities by industry

	Most common KAM	Percent	2 nd Most common KAM	Percent
Agriculture	Biological assets	25	Goodwill and intangible assets	18.33
Banks & financial services	Provision	48.57	IT related	14.29
Consumer goods & services	Goodwill and intangible assets	28.57	Business combination	15.71
Energy	Valuation of PPE	29.27	Other	21.95
Health care	Goodwill and intangible assets	47.62	Revenue recognition	23.81
Insurance	Insurance related	60	Taxation	40
Investment	Financial instruments	34.15	Valuation of PPE	17.07
Manufacturing and construction	Goodwill and intangible assets	27.59	Inventory	13.79
Mining, oil & gas	Asset impairments (not goodwill)	71.43	Revenue recognition	28.57
Non-profit	Financial instruments	100		
Properties	Valuation of PPE	69.05	Goodwill and intangible assets	9.52
Regulator / professional body	Goodwill and intangible assets	100		
Retail	Inventory	32	Lease related	20
Services	Goodwill and intangible assets	38.46	Revenue recognition	28.21
Transportation and communication	Valuation of PPE	28.57	Revenue recognition	19.05

KAM communications over time

KAM reporting includes some standardised information to provide context for users to understand the communication of KAMs. However, KAMs should be specific to the entity and to the audit that was performed to be relevant and meaningful to users. The level of detail and description of each KAM is a matter of professional judgement, and will vary depending on the circumstances. Such flexibility was designed to enable auditors to be as specific as possible, to mitigate concerns that the result could quickly become standardised.

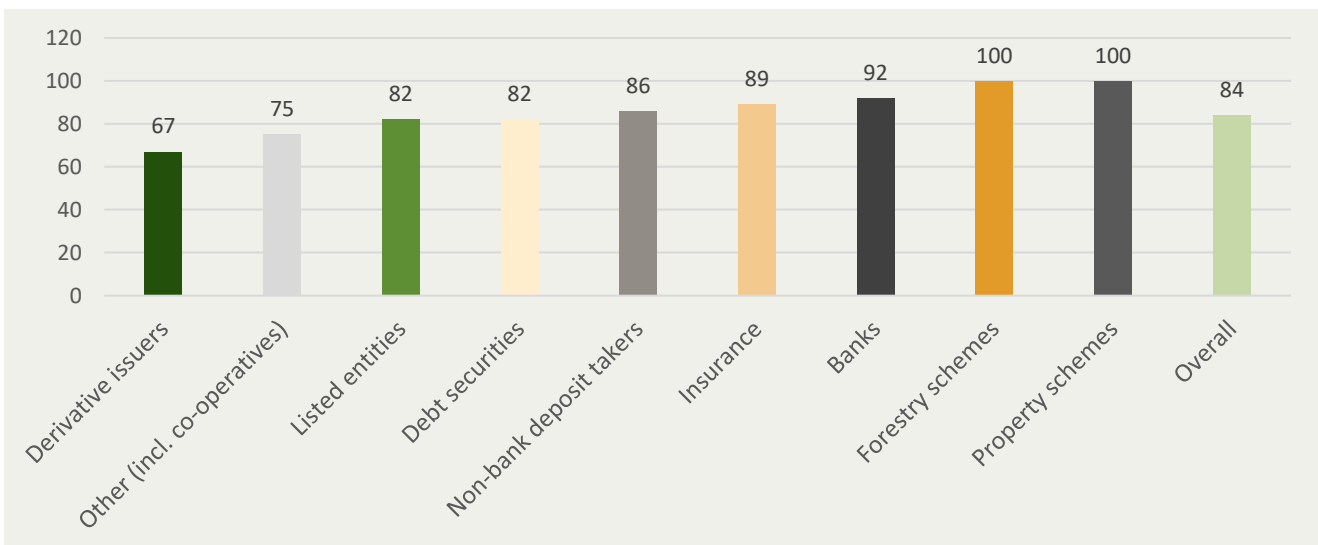
To understand how KAMs have changed over time, we compared the KAMs reported in 2021 to those reported in 2020 for each entity.

Repeated KAMs

To evaluate the stickiness of the reported KAMs (in other words, how persistent are the reported KAMs), we identified the number of repeated KAMs and the number of new KAMs disclosed in 2021 for each entity by comparing the KAM headings this year to those disclosed in the year before. Percent of repeated KAMs for each entity in 2021 is the number of repeated KAMs disclosed in 2021 divided by the total number of KAMs reported in 2021. An entity with 100% repeated KAMs would have disclosed the same KAM items in 2021 and 2020, whereas an entity with zero percent of repeated KAMs would have reported completely different KAMs in 2021 and 2020.

In Figure 3, we report the average percent of repeated KAMs by entity type. Overall, results suggest a high level of stickiness in the KAMs reported, especially for property schemes, forestry schemes, banks, insurance, and other financial institutions. The overall mean percent of repeated KAMs in 2021 was 84% for entities in our sample.¹

Figure 3: Reporting of repeated KAMs



¹We noticed that a matter may be described differently year-to-year. We categorised a KAM as repeated if the same topic had been disclosed in the previous year, even when the wordings used to describe the KAM (heading) were different. We noted 31 cases where a repeated KAM was described in a different way in the KAM heading in 2021 compared to 2020. An example is 'Impairment of goodwill and brands' and 'Goodwill and brands.'

New KAMs

Table 2 shows the number of new KAMs reported in 2021 by entity type. Of the 125 listed entities, 27 reported one new KAM, six reported two new KAMs, one had three new KAMs, and one had four new KAMs in 2021. Taking the sample as a whole, 23% of the sample had one or two new KAM in 2021, while those with three or more new KAMs were less than 1%. These results suggest that KAMs do change over time for some entities but the majority of the KAMs reported tend to be sticky (i.e., reported repeatedly) over time.

Table 2: Number of new KAMs

	Number of new KAMs in 2021 compared to 2020			
	= 1	= 2	= 3	= 4
Listed entities	27	6	1	1
Insurance	6	1	0	0
Other (incl.co-operatives)	6	0	0	0
Derivative issuers	2	0	0	0
Non-bank deposit takers	2	2	0	0
Banks	1	0	0	0
Debt securities	1	0	1	0
Forestry schemes	0	0	0	0
Property schemes	0	0	0	0
Total number of entities	45	9	2	1
% of sample	19%	4%	<1%	<1%

The new KAMs reported were mostly within the common KAM types (including impairment of assets, income recognition, accounting for leases, taxes, and provisions) and specific to the circumstances of the auditee (e.g., arising from business combinations, business closure, or going concern assessments).

We noted one new KAM that emerged in 2021 related to the accounting for Software-as-a-Service (SaaS) arrangements, for which an authoritative guidance was newly released by the International Financial Reporting Interpretations Committee (IFRIC) in April 2021. Four entities had a SaaS-related KAM reported in 2021.

Boilerplate language in KAMs

The inclusion of KAMs in the auditor's report was intended to enhance the communicative value of the report by providing more specific, useful and relevant information about the audit. While it is expected that there will be some standardised wording, the level of detail and description of each KAM is a matter of professional judgement for the auditor, and varies depending on the circumstances.

To evaluate the use of boilerplate (i.e., standardised) language in auditors' reporting of KAMs, we analysed the KAM section of the audit report using WCopyFind. WCopyFind is a programme that detects identical texts in a pair of documents it compares. It generates a comparison report and textual similarity scores for each pair of documents it compares.² We used this software to identify repeated/reused texts in the KAMs in 2021 by comparing them to the KAMs in 2020 for each entity.

Comparing the KAMs year-to-year for each entity revealed some standardisation in the wordings used by the auditors in reporting KAMs. Nevertheless, the wordings used in the KAM disclosures were rarely 100% identical, which suggests for most entities, KAMs were revised year-to-year to include disclosures more specifically related to the year of audit.

Figure 4a summarises the median KAM textual similarity scores. Forestry schemes, property schemes, and non-listed banking, insurance and financial institutions had higher similarity scores in their KAM disclosures than listed entities and derivatives issuers in the year of 2021.

Within listed entities, health care sector had the highest median similarity score, whereas entities in mining, oil & gas had the lowest similarity scores. We note that because we compared the KAM section as a whole, the higher the number of new KAMs in 2021 compared to 2020, the lower the textual similarity would be.

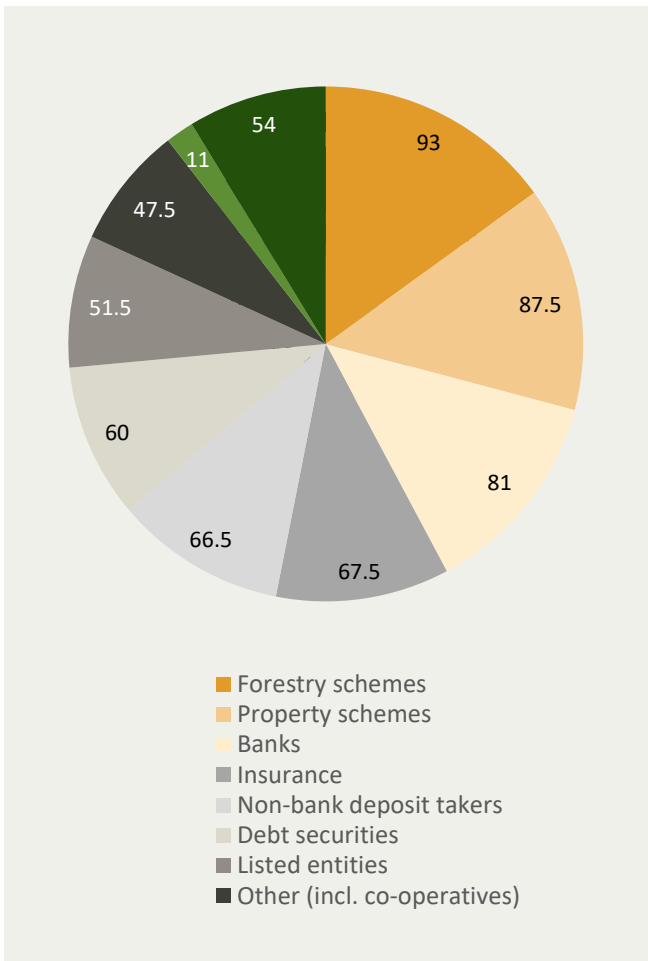
To further assess the extent of standardised language in the recurring KAMs, we restricted our analysis to 155 entities that had 100% repeated KAM items in 2021. As shown in Figure 4b, the median textual similarity score for this restricted sample was 66%.

Listed entities had a lower proportion of standardised language in their repeated KAMs compared to most of the non-listed entity types. For smaller entities, the KAMs reported had become highly standardised and may potentially become less useful to stakeholders over time when the KAM disclosures are mostly identical year-to-year.

² A detailed explanation on how WCopyFind works is available here https://plagiarism.bloomfieldmedia.com/How_WCopyfind_and_Copyfind_Work.pdf
We required the 'shortest phrase to match' to be four words.

Figure 4a: Year-to-year KAM textual similarity

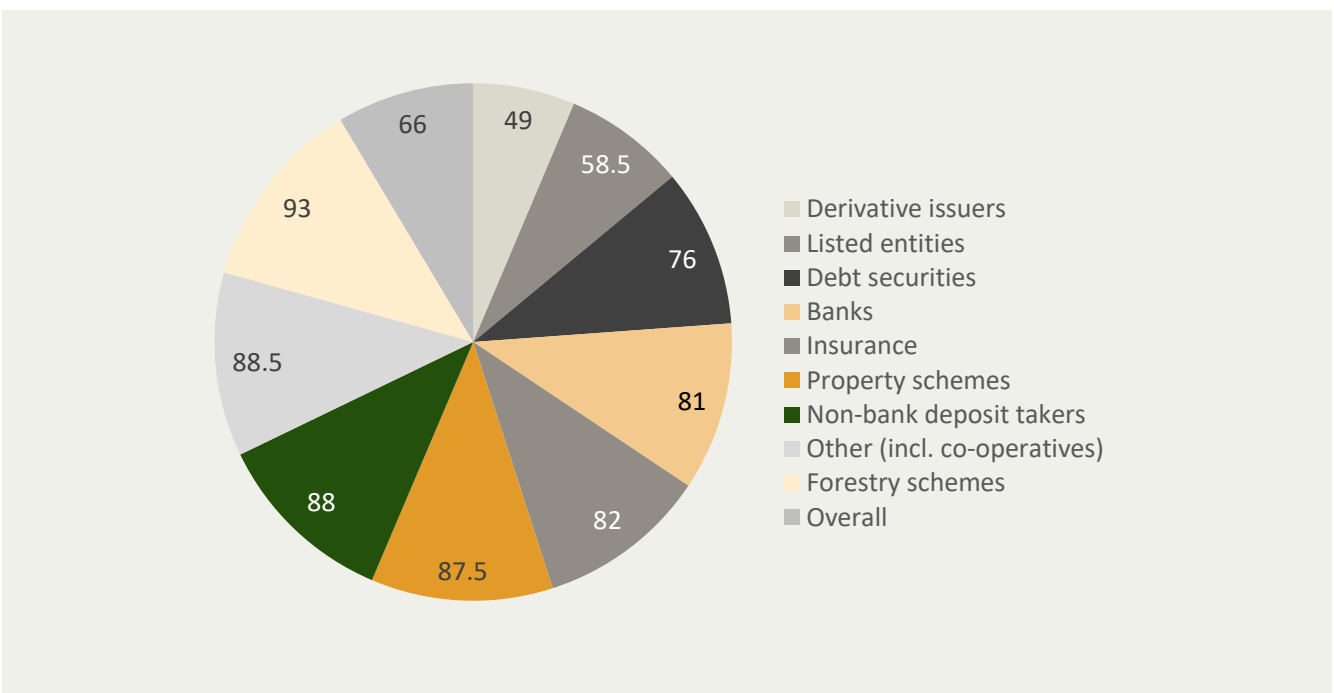
By entity type average similarity score



By Industry similarity score

Industry	Average Similarity Score
Health care	80
Energy	73
Services	69
Regulator / professional body	60
Investment	55
Properties	54
Insurance	51
Non-profit	51
Banks & financial services	49
Agriculture	44
Transportation and communication	41.5
Retail	34
Manufacturing and construction	32
Consumer goods & services	29
Mining, oil & gas	19

Figure 4b: Year-to-year KAM textual similarity for entities with 100% repeated KAMs



Diversity of KAM communications

In reviewing the KAMs reported, we noticed some diversity in the communication of KAMs on similar topics, as KAMs differed in length and the level of specificity, which we discuss in more detail in the next section. While we saw diversity in the communications of KAMs, there were also some standardised wordings used in the reporting of similar KAMs.

To gain an understanding of the extent of similarity and comparability of the KAM narratives on similar matters, we computed an average cosine similarity score for each KAM of an entity in a year by comparing it to all other KAMs on the same topic in that year disclosed for other entities. To estimate the level of similarity in the narratives between a pair of KAMs, we used the doc2vec model, following the method discussed in Guzman and Li (2022).³

As shown in Table 3a, the average textual similarity of a KAM compared to other KAMs on the same topic is about 50%. When we required the comparison to match on industry or auditor, the average similarity level was about 60%. The level of textual similarity between a KAM and its peers also varied by KAM types. As shown in Table 3b, for most KAM types, the textual similarity levels were higher for similar KAMs disclosed by the same audit firm and for similar KAMs in the same industry.

Overall, the results indicate a degree of textual similarity among KAMs on similar topics, and the level of textual similarity was higher when the clients were from the same industry and when the audit reports were issued by the same audit firm.

Two interpretations can be made from these findings. First, a higher level of textual similarity across similar KAMs indicates higher comparability between similar KAMs for different entities. Comparability may enhance the understandability of a KAM when users of the audit reports evaluate the financial information of different entities that had the same type of KAM.⁴ On the other hand, higher levels of textual similarity indicate more standardised language in the KAMs disclosed. Higher levels of generic, boilerplate language may hinder the usefulness and entity-specificness of the information provided in a KAM.

Overall, there seems to be a good balance between comparability and entity-specificness in the KAMs reported.

³Guzman, J., & Li, A. (2022). Measuring Founding Strategy. *Management Science*. <https://doi.org/10.1287/mnsc.2022.4369>

⁴The Conceptual Framework defines comparability as the “qualitative characteristic that enables users to identify and understand similarities in, and differences among, items”. It further states that “information about a reporting entity is more useful if it can be compared with similar information about other entities and with similar information about the same entity for another period or another date.” (<https://www.ifrs.org/content/dam/ifrs/meetings/2015/june/iasb/disclosure-initiative/ap11f-principles-disclosure-comparability.pdf>); see also De Franco, G., Kothari, S. P., & Verdi, R. S. (2011). The benefits of financial statement comparability. *Journal of Accounting research*, 49(4), 895-931-

Table 3a: Average % of textual similarity for similar KAMs

	Match on KAM type	Match on KAM type & industry	Match on KAM type & auditor
2020	51	60	60
2021	52	59	61

Table 3b: Average % of textual similarity by KAM type

	Match on KAM type	Match on KAM type & industry	Match on KAM type & auditor
Inventory	65	72	71
Going concern	63	35	34
IT related	63	71	74
Insurance related	62	63	68
Taxation	56	-	55
Biological assets	55	60	71
Provision	54	63	63
Revenue recognition	52	59	59
Asset impairments (not goodwill)	52	63	-
Business combination	50	38	60
Valuation of PPE	49	56	56
Lease related	49	-	-
Valuation of goodwill and intangibles	49	56	58
Financial instruments	46	64	55
Other	35	39	44

Understandability

To gain an understanding of the length, readability, and linguistic complexity of the KAMs disclosed, we looked at the length of the KAMs reported, as well as the reading ease of the KAM narratives.

Length

As shown in Figure 5a, the average length per KAM was between 200 and 400 words for most entities. The range of the average number of words per KAM reported was larger for listed entities, issuers of debt securities, insurance, banking, and financial services providers compared to the other entity types.

Within listed entities, one industry that stood out was the properties sector, which had the highest average KAM length in the two years we analysed. Entities in the properties sector, namely Kiwi Property Group (2021,2020), Investore Property (2020), and Metlifecare (2021), had the highest average number of words per KAM in the sample. These entities were all audited by PwC and had one KAM reported on the material valuation uncertainty in investment property valuations relating to COVID-19. SkyCity Entertainment Group Limited (2021) had the higher average length per KAM in the services industry. On the whole, there was not a big variation in the average length of KAMs across different industries.

Figure 5a: Average number of words per KAM by entity type

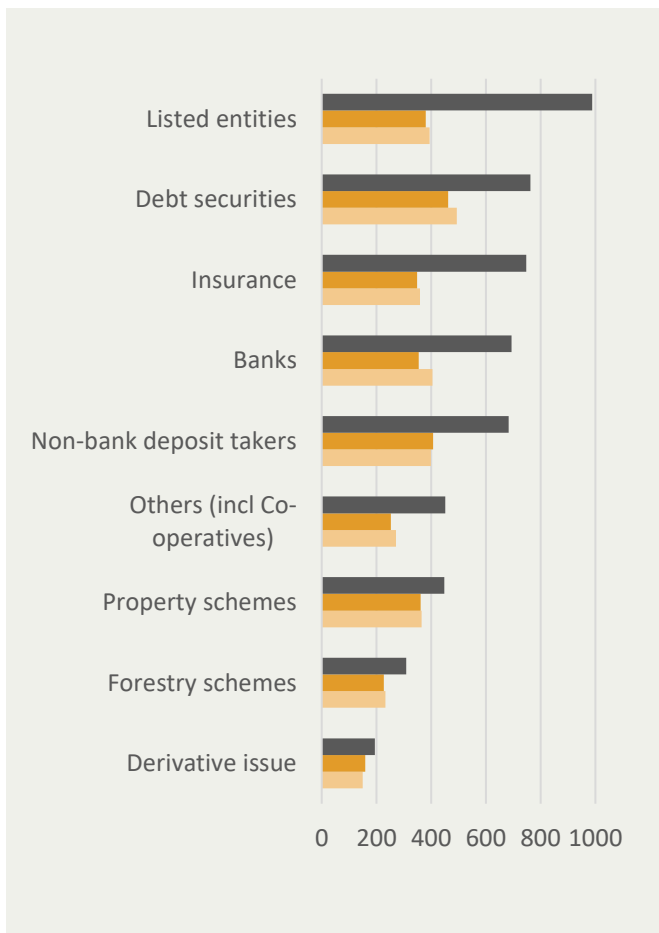
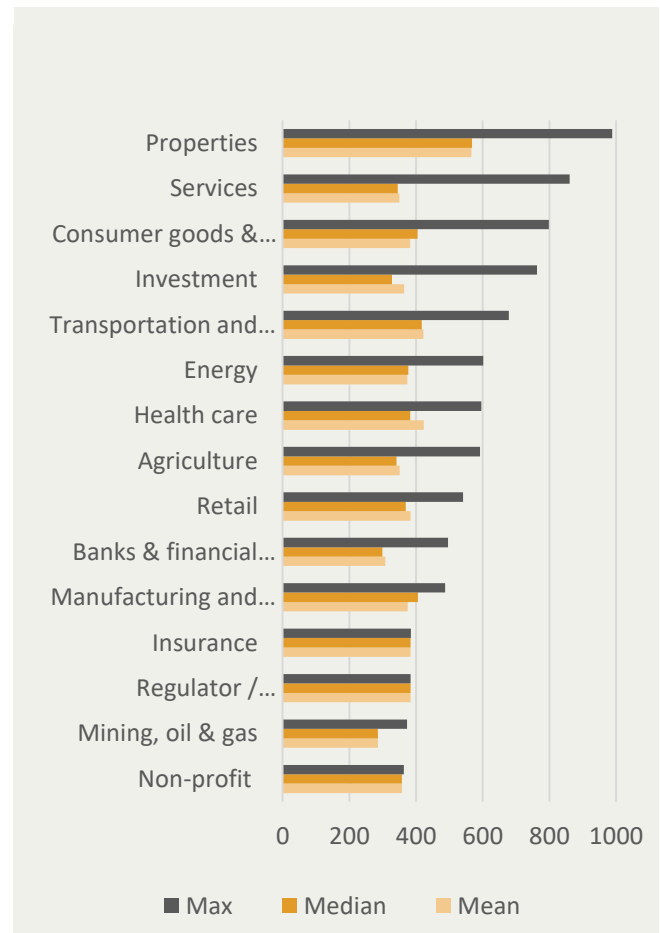
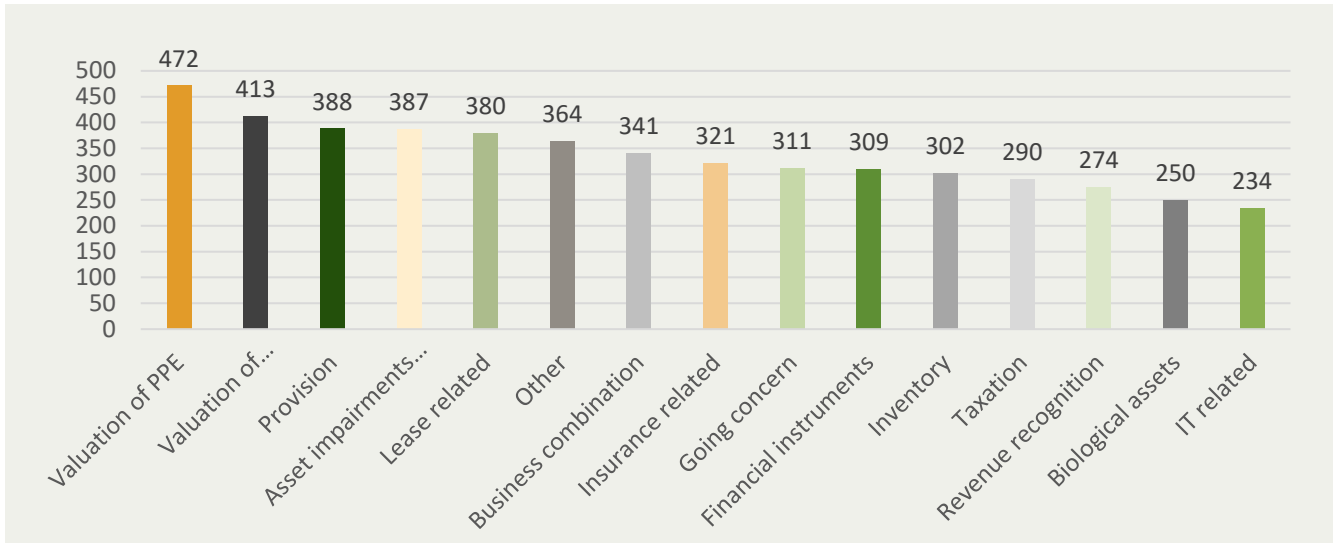


Figure 5b: Average number of words per KAM by industry



In terms of categories (shown in Figure 6), KAMs on valuation of assets, including PPE, goodwill and intangibles, were the longest on average during the 2020-2021 period. This was to some extent due to the Covid pandemic which brought about material uncertainty over the valuations of assets.

Figure 6: Average KAM length by KAM type Median KAM word count



Readability

To assess the readability of the KAMs, we computed a Flesch reading-ease score for each audit report's KAM disclosures.⁵

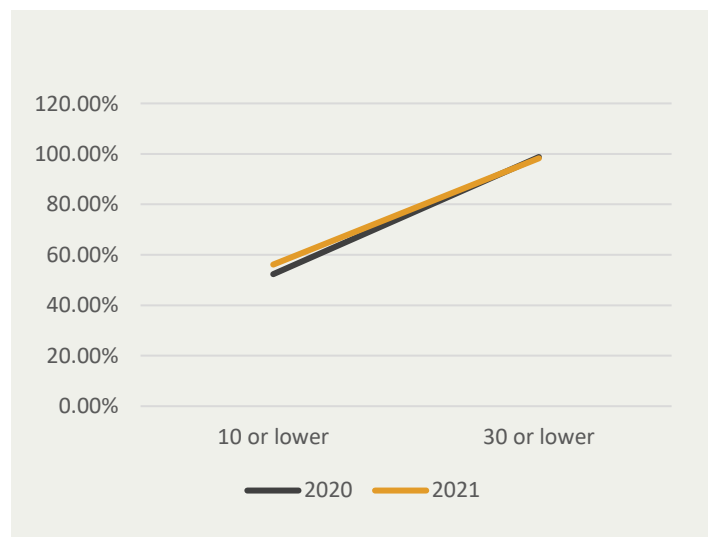
Less readable materials contain more complex sentences and more difficult words. Based on the Flesch reading-ease formula, a lower score indicates lower readability, as shown in Figure 7 (Flesch, 1948).⁶

Figure 8 reports our findings on the readability of KAM disclosures. As shown in Figure 8, narratives on KAM(s)' description and response had a score of 30 or below in over 98% of the sample, suggesting that most of the KAMs reported are very difficult to read. In addition, around half of the audit reports had KAMs that are 'extremely difficult to read' (a score of 10 or lower), which are best understood by professionals or readers with advanced university degrees.

Figure 7: Flesch reading-ease score description

"Reading Ease" Score	Description of Style
0 to 30	Very difficult
30 to 50	Difficult
50 to 60	Fairly difficult
60 to 70	Standard
70 to 80	Fairly easy
80 to 90	Easy
90 to 100	Very easy

Figure 8: KAM reading ease by year



⁵The Flesch reading ease formula is available here: <https://readabilityformulas.com/flesch-reading-ease-readability-formula.php>

⁶Flesch, R. (1948). A new readability yardstick. Journal of applied psychology, 32(3), 221.

KAMs are often about the most complex areas within financial statements, and often link directly to technical content in the financial statements.

Table 4 shows the KAMs' reading ease scores by entity type. The readability scores were below 30 for almost all entities, regardless of whether they were listed or non-listed.

Non-listed banks, insurance, and other financial services providers had a high proportion of audit reports with KAMs that are best understood by professional-level readers.

Overall, the results suggest that the narratives of KAMs contained many long sentences and/or complex words, which made the KAMs very difficult to read in over 90% of the audit reports we analysed. This indicates that KAM communications may not be easily understandable by all users of the audit report.

The prevalence of low readability in the KAMs disclosed in our sample of New Zealand entities is similar to the finding reported in Velte (2018), who examined a sample of UK-listed entities.⁷

We note that the Flesch reading-ease score has its own limitations (e.g., different use of punctuation will affect how sentence lengths are determined) so these findings should be interpreted with this in mind.

Table 4: KAM reading ease by entity type

	10 or lower %	30 or lower %
Banks	92.3	100
Insurance	79.07	100
Derivative issuers	75	100
Non-bank deposit takers	65.63	93.75
Other (incl. co-operatives)	56.67	96.67
Property schemes	50	100
Listed entities	41.73	98.43
Debt securities	40	100
Forestry schemes	30	100

Specificity

To understand the extent to which KAM communications were generic in nature (which can be applied to any similar auditee) or entity-specific, we looked at the number of times a specific entity was referred to in the KAM section of the audit report, where a specific entity can be a person, an organisation, a location, a monetary value, a date, a time, or a percent.⁸

Following the method discussed in Hope and Lu (2016)⁹, we used Stanford's Named Entity Recognition (NER) algorithm to detect the extent of discussing specific entities in auditors' KAM communications.¹⁰

⁷Velte, P. (2018). Does gender diversity in the audit committee influence key audit matters' readability in the audit report? UK evidence. *Corporate social responsibility and environmental management*, 25(5), 748-755.

⁸This measure of content specificity has also been interpreted as a measure of 'boilerplate', because a higher precision in the language suggests a less generic disclosure.

⁹Hope, O. K., Hu, D., & Lu, H. (2016). The benefits of specific risk-factor disclosures. *Review of Accounting Studies*, 21(4), 1005-1045.

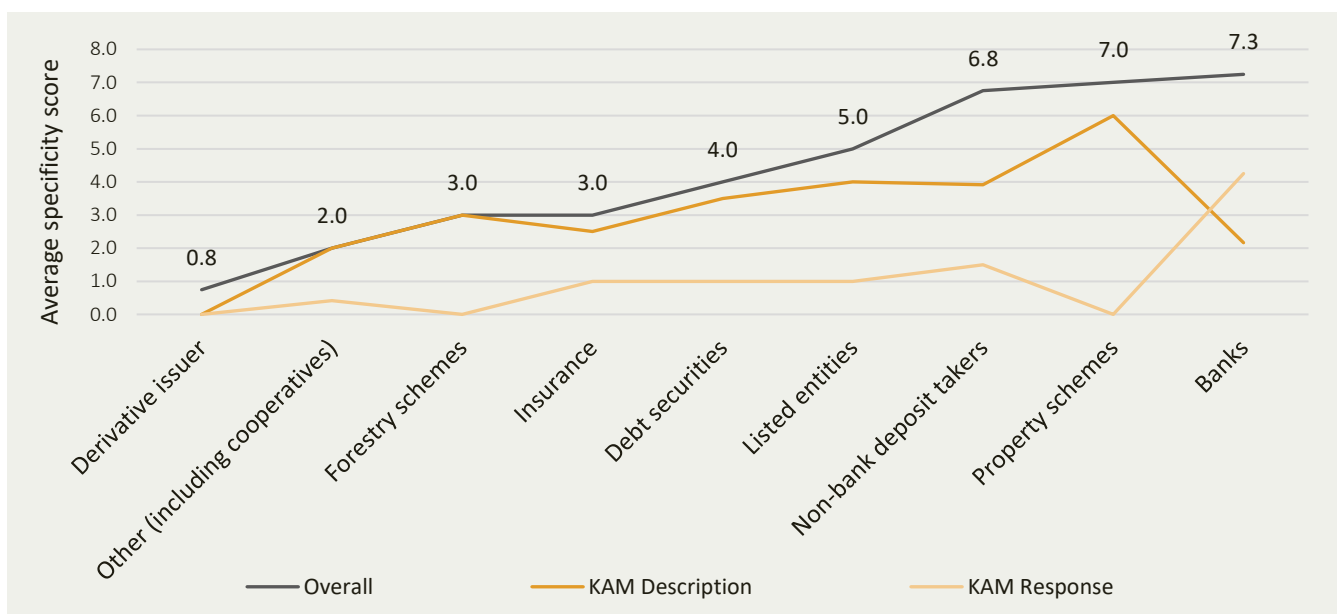
¹⁰We inspected the outputs generated by this algorithm and excluded entities that were incorrectly detected (e.g., accounting acronyms such as VIU or CGU were incorrectly detected as organisation names). We also excluded the count of phrases including the word 'Group' from this specificity count because auditors frequently used 'the Group' to refer to the auditee in KAM communications.

We computed the overall specificity score as the total count of specific entities in the KAM section of the audit report (including KAM heading, description as well as auditor's response) divided by the total number of KAMs disclosed, for each audit report. We also assessed the specificity of the narratives on KAM description and KAM response separately. Figure 9 plots the median specificity scores by entity type.

Among the non-listed entities, banks, non-bank financial institutions, and property schemes had more specific KAMs than the other entity types. Compared to the other entity types, non-listed banks also had the highest specificity in their KAM response narratives.

Listed entities had a median overall specificity score of five, suggesting that, on average, each KAM made five references to a specific organisation, location, monetary value, date, percent, or person. For most entities, KAM description contained more entity-specific information than the KAM response section of the disclosure.

Figure 9: Average specificity scores by entity type



Of the 435 audit reports that had at least one KAM disclosed, 98% had KAMs that included at least one specific entity(s) in the categories tagged by the NER algorithm. We inspected the KAMs of the eight audit reports that had no specific entities identified and concluded that these KAMs were nevertheless specific to the circumstances of the auditee.

In terms of KAM types, KAMs related to the valuation of PPE, financial instruments, business combinations, valuation of goodwill and intangibles, provisions, and other asset impairments contained more specific information relative to IT related and revenue recognition KAMs. The extent of specificity is also positively linked to KAM length.

Referring to note(s) of the financial statements

We looked at the extent to which KAMs cross referenced to section(s) of the financial reports. A high proportion of KAMs included a reference to specific note(s) of the financial statements. Specifically, of the KAMs reported in 2021, 80% made a reference to a 'note', and 69% mentioned the phrases 'financial statements' or 'financial reports.' KAMs reported in 2020 showed a similar pattern. With respect to entity type, around 85% of the KAMs for listed entities included a reference to a 'note', whereas the proportion of KAMs that cross-referenced section(s) of the financial reports for non-listed entities was slightly lower.

The extent of cross-referencing between KAMs and financial statement disclosures also varied by KAM types, as shown in Table 5, KAMs related to the measurement and recognition of financial statement items (e.g., goodwill, intangible assets, PPE, inventory, provision, revenue etc.) typically referred to specific sections of the financial reports. In contrast, KAMs related to the operating environment (e.g., IT related KAMs) less often cross-referenced to the entity's financial disclosures.

Table 5: Cross referencing between KAMs and financial statements

	% of KAMs mention 'note'	% of KAMs mention 'financial statements' or 'financial reports'
2020	80	70
2021	80	69
Listed	85	71
Non-listed	72	67
		% of KAMs mention 'financial statements' or 'financial reports'
	% of KAMs mention 'note'	
Valuation of goodwill and intangibles	89	79
Valuation of PPE	92	78
Revenue recognition	77	57
Financial instruments	78	63
Provision	70	65
Inventory	86	72
Asset impairments (not goodwill)	81	63
Other	78	82
Taxation	75	60
Biological assets	76	44
Going concern	100	100
Insurance related	85	76
IT related	21	27
Lease related	88	88
Business combination	80	70

Voluntary Reporting

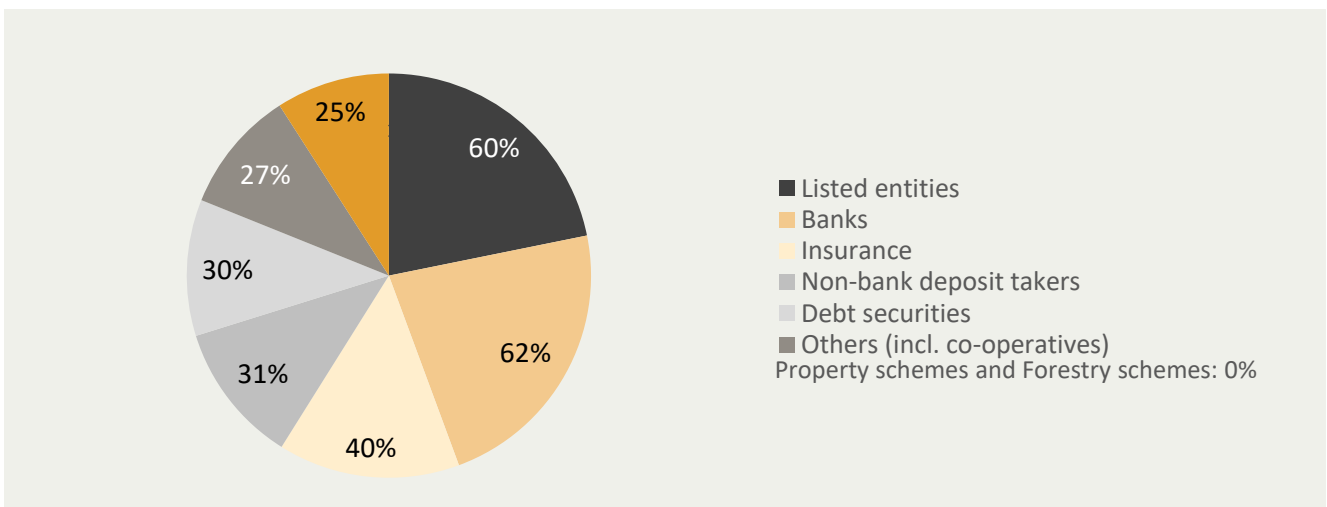
Similar to the findings reported in prior reviews, our analysis identified that some auditors have gone beyond what is required by the current auditing standards in New Zealand and provided additional information in areas of materiality, audit scope, and outcome of audit procedures.

Materiality

Overall, 49% of the sampled audit reports in 2021 included a materiality disclosure. The reporting of audit materiality varied by entity types as shown in Figure 10. Auditors disclosed materiality for 60% of the listed entities; among non-listed segments, auditors reported on materiality more often for entities in the financial services and insurance sectors.

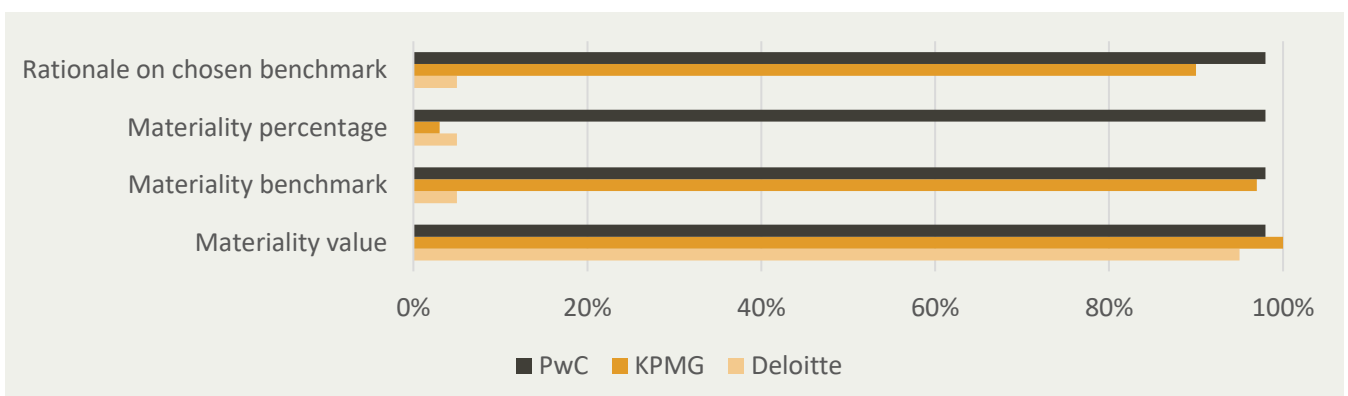
PwC remained the only audit firm that consistently reported on materiality for both listed and non-listed entities – all but one audit reports of PwC reported on materiality (98%) in 2021. KPMG and Deloitte reported on materiality for over 80% of their listed clients, but had a less consistent approach in their materiality reporting for non-listed clients. Overall, they disclosed materiality in around 63% of the audit reports, including listed and non-listed entities, in 2021, which is slightly lower compared to 2019. EY reported on materiality for only one NZX listed entity in our sample. This one audit report was issued by EY Edinburgh and the entity is cross-listed in the UK. EY New Zealand and the small-to-medium sized audit firms did not report on materiality. Overall, the reporting of audit materiality has stayed relatively stable for most audit firms, but we saw a slight decline overall in 2021 compared to 2019.

Figure 10: Materiality reporting by entity type in 2021



Most auditors that reported on materiality included a monetary value; PwC and KPMG also reported on the materiality benchmark used and the rationale on the chosen benchmark.

Of the materiality disclosures



Benchmarks

The most common materiality benchmark disclosed in 2021 was profit before tax (PBT) and its many variations, including adjusted PBT, EBITDA, EBITDAF, and weighted average adjusted PBT. Interestingly, a weighted average approach in determining audit materiality was used in 2020 and 2021 by PwC (and this benchmark was not observed in prior periods' reviews). The weighted approach aims to reduce the significant temporary impact of Covid on the key performance metrics. PwC applied a three-year weighted average adjusted PBT for a number of listed entities and non-listed banking and insurance providers in 2020 and 2021, as this measure was considered more stable and representative of the entity's long-term performance. The other commonly reported materiality benchmarks were revenue, net assets and total assets. These observations were comparable to those discussed in the prior XRB/FMA reviews.

The top three materiality benchmarks reported for listed entities in 2021 were (a form of) PBT, revenue, and net assets; for non-listed banks, PBT and net assets; for insurance providers, premium revenue, PBT, and net assets; for non-banking financial institutions, the benchmarks were mostly net assets. In rare cases, the benchmark used was very specific to the business environment of the entity, e.g., the cost of New Zealand source milk was used as the materiality benchmark for Fonterra.

Audit scope

Overall, auditors disclosed on audit scope in 29% of the audit reports sampled in 2021, which is a level similar to the reporting of audit scope by auditors in 2019. PwC included a discussion on audit scope in all but one audit reports in 2021. KPMG included a separate disclosure on audit scope in 13% of their audit reports. EY, Deloitte and other audit firms did not report on audit scope.

We note that auditors' disclosure on audit scope varied in length based on the complexity of the entity audited. For example, the disclosure on audit scope for Fonterra was close to 500 words (8 paragraphs), while other disclosures on audit scope were mostly between one to three paragraphs in length.

PwC and KPMG each had a standardised paragraph in all their audit scope disclosures:

"The scope of our audit is designed to ensure that we perform adequate work to be able to give an opinion on the consolidated financial statements as a whole, taking into account the structure of the Group, the financial reporting systems, processes and controls, and the industry in which it operates." (KPMG)

"We tailored the scope of our audit in order to perform sufficient work to enable us to provide an opinion on the financial statements as a whole, taking into account the structure of the Group, the accounting processes and controls, and the industry in which the Group operates." (PwC)

We noticed that in a few PwC audit reports, there was no entity-specific disclosure on audit scope (only the standardised disclosure above was included). Overall, the level of entity-specific detail provided in the audit scope disclosures varied as this is not a regulated area.

Outcome of audit procedures in KAMs

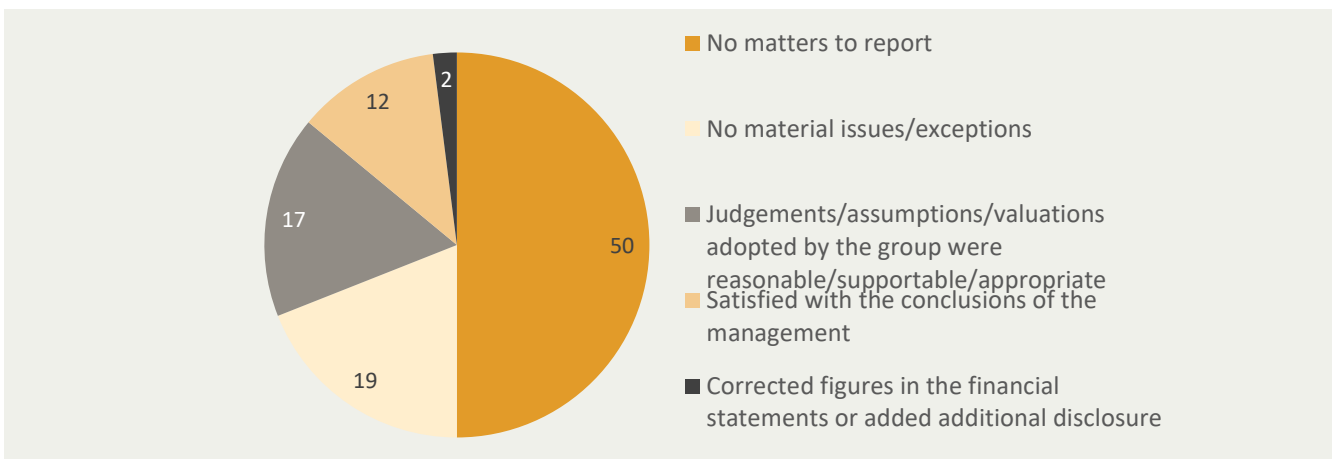
In 2021, 22% of the KAMs included a disclosure on the outcome of audit procedures within individual KAMs.

In 98% of the KAMs that disclosed an outcome of audit procedures, auditors noted that they “had no matters to report from the procedures performed”, found “no exceptions” or “material errors”, or that they were ‘satisfied’ with the assumptions/judgements/valuations of the management, or found them “reasonable/supportable/appropriate/balanced.’

In 2% of the outcomes disclosed, the auditor’s report noted correcting journal entries or additional disclosures were provided as a result of their audit procedures.

PwC and KPMG more frequently reported on outcomes of audit procedures in their KAMs than EY, Deloitte and other audit firms in 2021. Overall, the Big 4 audit firms, and the other audit firms discussed outcomes of audit procedures in 26%, and 13% of their KAMs in 2021, respectively.

Figure 11: Outcome of audit procedures



Non-standard reports

Ninety-nine percent of the auditor reports within the sample included a “clean” opinion, i.e., that the financial statements present fairly, in all material respects, the financial position, financial performance and cash flows for the year.

Modified Opinions

There were seven qualifications in our sample where auditors were unable to obtain sufficient appropriate audit evidence to support certain reported carrying values in the financial statements. The seven qualifications were for five listed entities (two entities received qualified opinions in both years). One of the five entities was delisted from the NZX main board and ceased trading in 2022. Along with the qualified opinion, the auditor expressed a material uncertainty related to going concern (MURGC) in two audit reports, and an emphasis of matter (EOM) in one audit report.

There were two cases of disclaimer, one in 2020 and one in 2021, for two listed entities. In these cases, auditors have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements and thus did not express an opinion on the financial statements. A disclaimer is only used when the auditor has exhausted all avenues to get the evidence needed to form an opinion. Auditors provided extensive explanations on the basis for disclaimer.

It is relatively unusual for auditors to modify their opinion. The frequencies of MURGC, qualified, and disclaimer audit opinions in 2020/2021 were comparable to those reported in the 2019 review.

Table 6: Frequencies of non-standard audit reports

	MURGC	EOM	Qualification	Disclaimer
2020	15	16	3	1
2021	10	10	4	1
Total	25	26	7	2

Emphasis of Matter (EOM)

Auditors have other tools to enhance the communicative value of their report. An emphasis of matter paragraph refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor’s judgement, is of such importance that it is fundamental to users’ understanding of the financial statements.

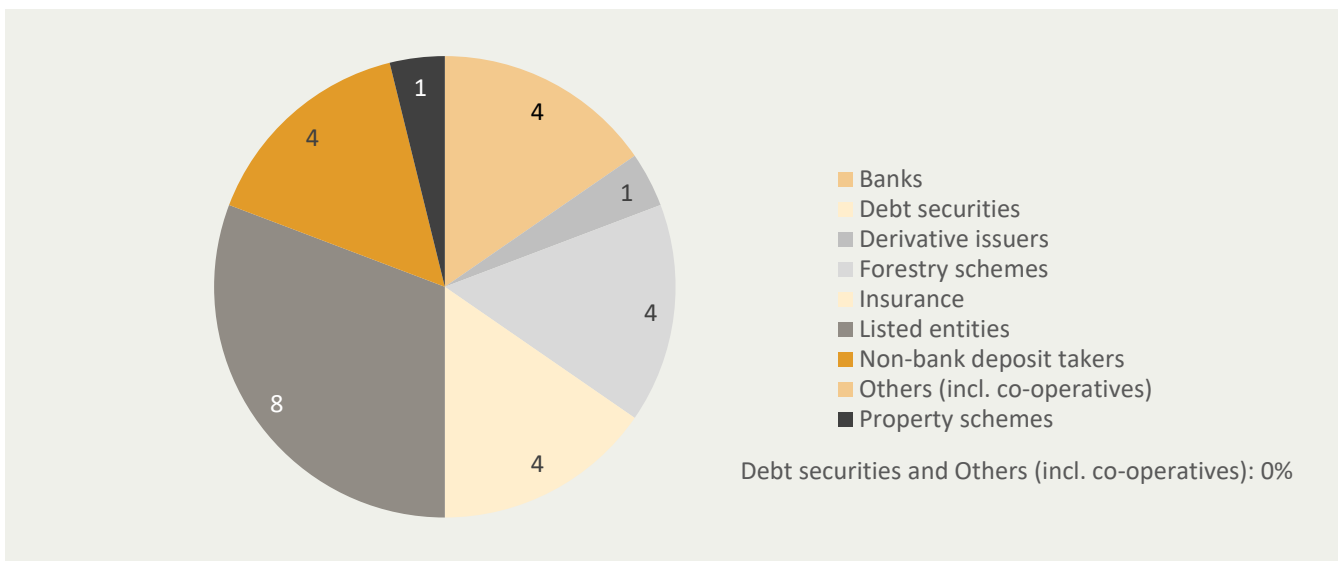
Relative to prior years' reviews, we observed a higher number of audit reports with EOM paragraphs during the period from 2020 to 2021. Specifically, 2 cases of EOM were identified in 2019, as compared to 16 cases in 2020 and 10 cases in 2021.

We noticed EOMs arising from Covid being reported, which to some extent explained the higher number of audit reports with EOMs during this period compared to prior periods. Of the 26 audit reports with EOM reported, 50% were in the insurance, banking, or non-bank financial services sector.

Figure 12 provides a breakdown of the occurrence of EOMs by entity type. Only 3% of the listed entities received audit reports containing EOMs. Non-listed entities, especially banks, non-bank financial institutions, forestry schemes and property schemes had a higher proportion of audit reports with EOMs.

We note that the use of EOMs in New Zealand is more common than in other countries such as the UK.

Figure 12: EOMs by entity type



Special topics

Covid-related KAMs

To evaluate the extent of the impact of Covid-19 on auditors' reporting of KAMs, we searched for Covid-related discussions in the KAM section of the audit reports. Figure 13 shows the proportion of audit reports that mentioned the impact of Covid in the KAM disclosures.

In 2020, 60% of the audit reports in our sample mentioned 'Covid' in the reporting of KAM(s). The proportion of audit reports that mentioned the impact of Covid in the KAM section was lower in 2021 (39%).

Looking at the proportion of audit reports with Covid-related KAM(s) by entity type, all property schemes had a KAM that referred to the impact of Covid. Over 50% of the audit reports for banks, non-bank financial institutions, and listed entities had Covid-related discussions in the KAM communications.

In terms of industry breakdown within listed entities, over 70% of the audit reports in insurance, retail, health care, and properties sectors mentioned the impact of Covid in the KAM disclosures. Most other industries also had KAMs that referred to the Covid pandemic.

The above findings were based on Covid-related discussion in the entire narrative of the KAM section (including KAM heading, description, and response). We also found 44 cases where the impact of Covid was disclosed in a more prominent place, namely in the heading of a KAM. Among the KAMs mentioning Covid in the heading, a high number related to the valuation and impairment of assets.

Figure 13: Covid-related KAM reporting

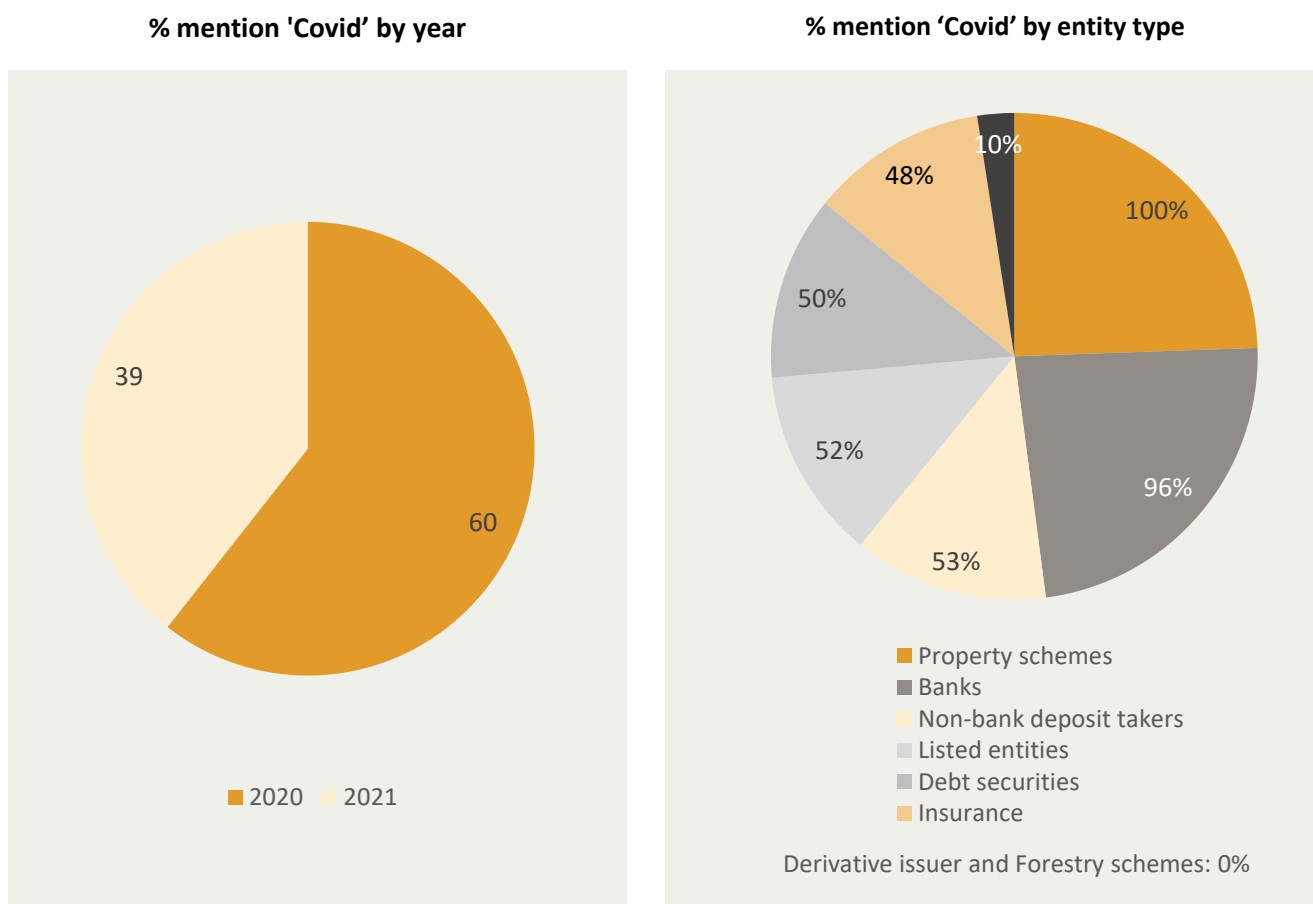


Table 7a: 'Covid' by industry

	% mention 'Covid'
Insurance	100
Retail	90
Health care	81
Properties	77
Transportation and communication	55
Banks & financial services	50
Consumer goods & services	50
Non-profit	50
Agriculture	46
Energy	44
Services	44
Investment	39
Mining, oil & gas	33
Manufacturing and construction	21
Regulator / professional body	0

We also looked at the frequency of Covid being mentioned in different types of KAMs, as shown in Table 7b.

KAMs related to the valuation of assets, including PPE, inventory, goodwill and intangibles discussed the impact of Covid more frequently compared to KAMs related to IT system, and taxation.

Table 7b: Covid-related KAM reporting by KAM type

	% mention 'Covid' in KAM heading	% mention 'Covid' in KAM description	% mention 'Covid' in KAM response
Valuation of PPE	14	56	53
Valuation of goodwill and intangibles	8	34	43
Provision	2	48	43
Insurance related	4	26	32
Inventory	14	31	31
Financial instruments	2	25	27
Other	16	35	27
Going concern	0	22	22
Biological assets	0	12	20
Asset impairments (not goodwill)	0	33	19
Revenue recognition	0	9	17
Business combination	0	15	15
Lease related	0	3	9
Taxation	0	0	5
IT related	0	0	3

Climate-related KAMs

We found only three cases where auditors referred to climate risk in the reporting of KAMs in the 470 audit reports analysed. The three cases were for three different listed entities¹¹, all in 2021. Of the three entities, two were in the energy sector and one in the agriculture sector.

In these instances, auditors noted the risk of climate change on the valuation or impairment of assets. However, the mention of climate risk in these KAMs was very brief and general (quotes provided below).

"The valuation also reflects assumptions relating to changes in demand in response to climate change."

"We considered the impairment assessment of the Gas Trading segments to be a key audit matter due to the competitive margin trading environment and the potential impact of the response on the global climate change."

"Holding discussions with management and considering market information to identify factors, including environmental/climate or market risks, that would impact the current crop valuation, including consideration of the impact of COVID-19."

Different from the findings in the UK,¹² we found no KAM that specifically discussed climate related issues in our sample of New Zealand-listed and non-listed entities.

Because we found three cases of KAMs with climate-related narratives in 2021 but none in 2020, it could suggest an increasing trend for auditors to consider and disclose the impact of climate-related risks on the audit of financial statements.

¹¹The three entities were Genesis Energy, Scales Corporation Limited, and Vector.
¹²<https://www.frc.org.uk/getattachment/46404ede-df44-4c95-9384-95a4dc18ef21/Snapshot-4-Climate-change,-COVID-19,-alternative-performance-measures,-and-graduated-findings.pdf>

Going concern

Material uncertainty related to going concern (MURGC) sections were reported more often than going concern (GC) KAMs during the period 2020-2021, similar to the results of the 2019 XRB/FMA review.

	Where the auditor concludes that there IS a MURGC	Where the auditor concludes there IS NOT a MURGC, but the use of the going concern assumption is identified as a KAM
Reporting approach required by the standard	The MURGC is, by nature, a KAM but it is communicated in a separate section in the auditor's report.	Going concern can be a "close call". The auditor may have made significant effort to gain comfort that the use of the going concern assumption was appropriate and therefore identify going concern as a KAM
2019	14 examples	5 examples
2020	15 examples	5 examples
2021	10 examples	4 examples

Twenty-five audit reports (5% of the sample) contained a MURGC section, fifteen in 2020, ten in 2021. Seventeen entities received audit reports containing a MURGC (eight entities received MURGC for two consecutive years), of which three were non-listed and 14 were listed. Among the 22 audit reports for listed entities with MURGC, 41% were in consumer goods & services, 27% in investment, and 23% in services industries.

Auditors' communication of MURGC showed a standard pattern: "We draw attention to ... which indicates a material uncertainty that exists that may cast significant doubt on the entity's ability to continue as a going concern. Our opinion is not modified in this matter."

Nine audit reports (2% of the sample) contained a GC KAM, five in 2020, four in 2021. The GC KAMs were for five listed entities (three in manufacturing and construction, one in investment, one in energy), and four non-listed entities (two non-bank deposit takers, and two others). The frequencies of MURGC and GC KAMs were comparable to those identified in the 2019 XRB/FMA review.

In terms of the narratives, GC KAMs contained more detailed descriptions about the matter, while the MURGC paragraph was more standardised and streamlined in its description. Most auditors reported KAMs using a tabular format, whereas MURGCs were communicated in one to two paragraphs in most audit reports.

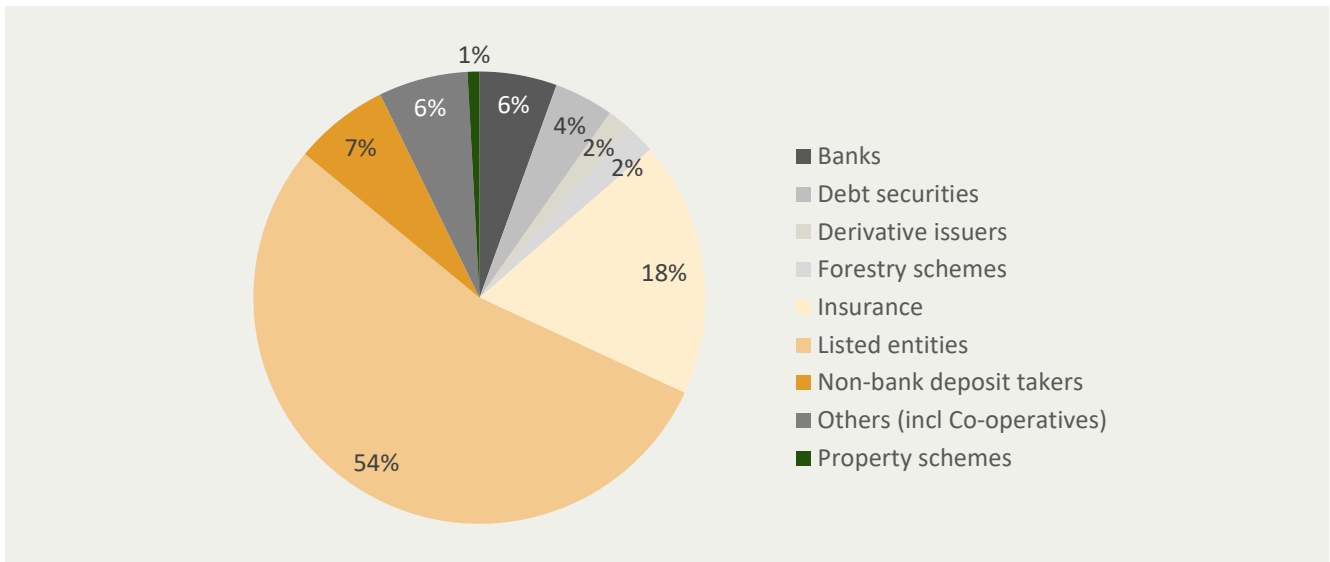
In one audit report, the auditor used a KAM format in reporting a MURGC. The KAMs of this audit report were disclosed in a separate section. GC KAM and MURGC did not exist concurrently in any of the audit reports in our sample.

Appendix A: Sample Overview

Table A: Sample composition by entity type

	Listed entities	Banks	Non-bank deposit takers	Insurance	Debt securities	Derivative issuers	Others (incl. co-operatives)	Property schemes	Forestry schemes	Total
2020	127	13	16	43	10	4	15	2	5	235
2021	127	13	16	43	10	4	15	2	5	235
Total	254	26	32	86	20	8	30	4	10	470

Figure A: Sample composition by entity type



Similar to the joint research undertaken by the XRB and the FMA in 2019, we collected the audit reports of nine types of entities that are required to follow the auditing standards on KAM reporting. Our sample included 470 audit reports for 235 unique entities, covering two consecutive years from 2020 to 2021 for each entity. The sample was most represented by listed entities (54%), followed by non-listed insurance (18%), banking (6%) and non-banking financial institutions (7%). Issuers of derivatives (2%) and debt securities (4%), forestry (2%) and property schemes (1%), and others (6%) made up a small portion of the sample.

Within the sample of audit reports we analysed, 26% were issued by PwC, 20% by KPMG, 15% by Deloitte, and 11% by EY. In total, the 'Big Four' audit firms audited 72% of the sample, and the remaining 28% of the sample were audited by small-to-medium sized audit firms.