



# Snapshot 4: Climate change, COVID-19, alternative performance measures, and graduated findings



## Introduction

This snapshot provides a deep dive into aspects of the Key Audit Matters (KAMs) that are included within our sample auditor's reports. We considered audit risks posed by climate change and COVID-19, which vary from company to company. Auditors have adopted several different approaches to detailing their response to these risks. We also reviewed the treatment of alternative performance measures (APMs) and exceptional items as KAMs, and the use of graduated findings to report the conclusions of the auditor on KAMs, since both these matters have attracted attention.



## 1 Climate change

KAMs related specifically to climate change risks were rare. Out of a total of 1,306 KAMs reviewed for 396 reports, only 4 included separate KAMs on the matter. The companies involved were BP, Shell, National Grid, and Glencore.

It is important to note that the absence of climate change related KAMs does not necessarily reflect an absence of climate change related work within an audit. Other KAMs, for example relating to expected credit losses or provisions for decommissioning assets, may include references to the impact of climate change. A recent FRC report has noted an increased engagement with climate change risks by auditors, in particular during the risk assessment stage. However, unlike the approach adopted by some reports in response to the COVID-19 pandemic, auditors did not generally choose to identify climate change as a cross-cutting risk to the financial statements that merited treatment as a KAM for the surveyed reports.

A larger number of reports did include information on the impact of climate change on the audit work performed (Figure 1). A total of 36 reports included a specific discussion on the impact of climate change considerations on the audit as part of the overall risk assessment. These discussions were most common within the FTSE 100 segment, with a taper through the FTSE 250 to large AIM companies. A further 5 reports included a specific section on climate change – the companies in question were BHP Group, Barclays, Diageo, 3i Group, and Rio Tinto. All these companies were constituents of the FTSE 100.

This is a fast-moving area of change, and auditor's reports issued 18 months ago may not be reflective of current practice. The introduction of TCFD disclosures may also result in increased commentary within the auditor's report with respect to the auditor's responsibilities for other information included in the annual report. A like-for-like comparison, where possible, with more recently issued auditor's reports for the same companies in the sample did not indicate a significant change in the number of KAMs related to climate change.



## 2 COVID-19

The COVID-19 pandemic has been the most significant period of economic turbulence since the Financial Crisis of 2008, which prompted the introduction of extended auditor reporting. Auditor reporting on the impact of the pandemic therefore provides an opportunity to understand how auditors respond to difficult and pervasive economic conditions.

Auditors adopted two approaches for communicating the financial statements risks posed by COVID-19. The first was to include a thematic KAM on COVID-19. The alternative was to include specific

considerations within individual KAMs. The frequency with which this risk was discussed in auditor's reports also varied between different market sectors.

A total of 103 auditor's reports, or 26% of all reports, followed the first approach and included a thematic KAM on COVID-19 (Figure 2). These were most common for FTSE 250 companies, and least common for large AIM concerns. However, 97 of these reports were issued by a single audit firm, out of a total of 100 of their reports included within the sample. These KAMs often did include risks relating to going concern, but also included other identified risks of material misstatement in relation to financial statement line items.

The alternative approach was to include a discussion of the impact of COVID-19 within individual KAMs (Figure 3). The impact of the pandemic was most reflected within a KAM on going concern. Other KAMs that commonly included a discussion of the pandemic were those that related to the valuation of assets, such as impairments, goodwill, expected credit losses, and the valuation of investments.

Further information on auditors' reporting on going concern is included in Snapshot 5.

The impact of the pandemic also varied according to industrial sector (Figure 4). Overall, 64% of reports in the sample included a consideration of how COVID-19 affected the auditor's assessment of risk. However, this obscures the degree of variation between the different sectors. For example, all auditor's reports issued for banks referred to the impact of COVID-19. Over 90% of reports for companies in the travel and leisure, insurance, and constructions and materials sectors also referred to the pandemic. At the other end of the scale, reports issued for the technology, automotive, energy, and financial services (other than banks) sectors discussed the impact of COVID-19 with less frequency.

In addition to discussing the impact of the pandemic on risks to the financial statements, several auditor's reports included commentary on how the performance of the audit was affected. These were primarily (though by no means exclusively) issued by one firm and included commentary on the logistical challenges of performing the audit during lockdown conditions and with restrictions to international travel. They also set out how the group audit team directed and reviewed the work of component audit teams.

Fig. 2: Prevalence of COVID-19 KAMs

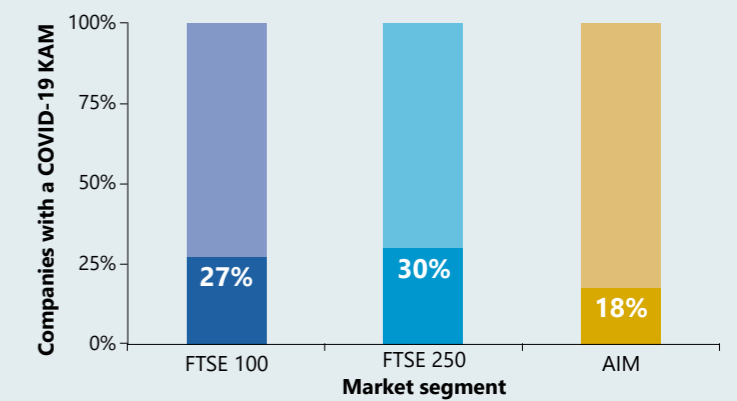
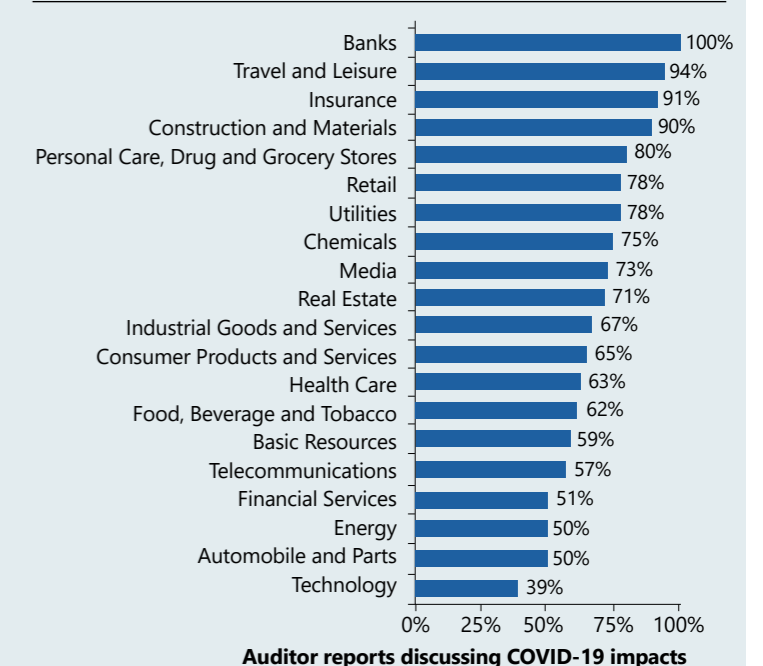


Fig. 3: Areas of COVID-19 related impacts in KAMs



Fig. 4: KAMs discussing COVID-19 by sector



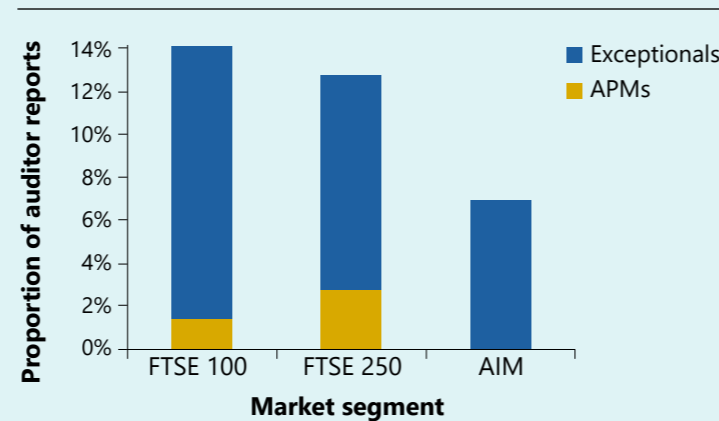
### 3 Alternative Performance Measures and Exceptional Items

The extent of assurance over APMs has attracted attention over recent years, particularly as they are widely used by financial analysts. In a very small number of cases were considered as KAMs by auditors. As APMs are non-GAAP measures, they do not automatically form part of the auditor's opinion. APMs only form part of the auditor's opinion on the financial statements when, in the auditor's professional judgement, they are integral to the financial statements. This is due to the nature of the APMs, or how they have been presented. Even in such circumstances, auditors may not be of the view that their work over APMs are KAMs.

As **Figure 5** shows, it is rare for auditor's reports to include KAMs on either APMs or exceptional items. Only three reports, from the 396 in the sample, include a KAM on APMs such as earnings before interest, taxes, depreciation, and amortisation (EBITDA). The trigger for inclusion as a KAM was the use of these APMs in management commentary on the performance of the company.

KAMs to address items of expenditure or income within the financial statements that have been classified as exceptional by the company were more common. Unlike APMs, Exceptional items are GAAP measures tend to be the classification of one-off costs distinct from 'underlying' measures of profitability or liquidity. A total of 33 instances were observed in the sample, which corresponded to 3% of all KAMs and 8% of all auditor's reports. These KAMs were most common for FTSE 100 companies, and least common for large AIM companies. The clear majority (74%) of these KAMs related to how profit had been presented within the income statement. The remainder considered the classification of restructuring costs (13%) and the treatment of equity financing within the balance sheet (10%).

**Fig. 5: APM and exceptionals KAMs in auditor reports**



### Summary

- Risks associated with **climate change** were rarely reported as KAMs for the auditor's reports in the sample.
- Auditors diverged in their response to the risks associated with the **COVID-19 pandemic**. The most common response was to integrate the risk within a consideration of the underlying financial statement line item.
- KAMs on **APMs** are very rare, though these are more common for exceptional items and the presentation of profit in the income statement.
- The use of **graduated findings** is rare. Binary findings are more common, and both approaches use simple, formulaic approaches to express conclusions.

### Acknowledgements

This snapshot is based on an analysis of 396 auditor's reports issued during 2021, and commissioned by the FRC from a team of academics based at the Universities of Portsmouth, Southampton, and Brunel.



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### 4 Graduated findings

The use of graduated findings in the auditor's reports in our sample was rare, though the related approach of reporting binary findings was more common. The approaches used to communicate graduated findings were relatively simple and formulaic.

The potential use of graduated findings to communicate auditor findings has attracted attention over recent years as a potential enhancement to auditor reporting. A graduated finding is where the auditor expresses a view on key management estimates and judgements within the financial statements by describing their position on a range of potential outcomes. An alternative but related approach is the use of binary findings, where the auditor's reports on the comparison of management's point estimate with the plausible range of values identified by the auditor. In both cases, the natural place to include such findings are within discussions on KAMs.

Both approaches are rare (**Figure 6**). Only 9 auditor's reports in the sample, out of 396, include graduated findings. All of these reports were issued by a single firm. Binary findings were more common, being included in 47 auditor's reports. The usage of these approaches was most frequently in reports issued for FTSE 100 companies (20%) and were least common for large AIM companies (9%).

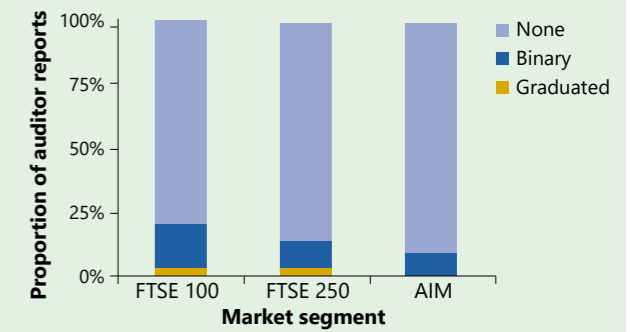
The financial statement line items to which graduated and binary findings were applied is set out in **Figure 7**. The recoverability of investments, at 37%, was the most common type of KAM to use these approaches. This approach was also frequently used in KAMs on intangible assets and the valuation of financial instruments. Revenue recognition was also common, the context here being the setting of the recognition point for revenue through the use of management judgement.

**Figure 8** sets out the language used by graduated and binary findings. The language is simple and generally formulaic. Graduated findings were reported on a simple scale, describing management's approach as 'cautious', 'balanced', or 'optimistic'. Occasionally, additional qualifiers were used: for example, an estimate might be described as 'slightly cautious' or 'mildly optimistic'. The disclosures in the financial statements for this line item are then described as either 'proportionate' or 'light'.

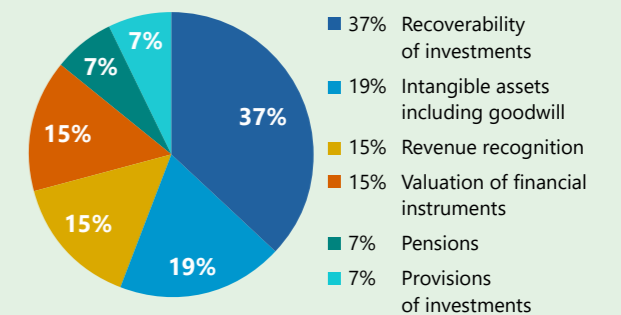
Binary findings express whether the estimate sits within a range of values that the auditor has deemed as acceptable. In a small number of cases, an additional qualifier was provided, such as stating that the estimate is 'acceptable but optimistic' or 'acceptable but cautious'. This was similar to the approach adopted for graduated findings.

In addition, there were a few instances where the auditor noted that an underlying estimate adopted by management lay outside the range of values identified by the auditor, but that this had no material impact on the final balance included in the financial statements.

**Fig. 6: Use of graduated and binary findings**



**Fig. 7: Areas where graduated and binary findings are used**



**Fig. 8: Language used by graduated and binary findings**

