Snapshot 3: Key Audit Matters

Introduction

Key audit matters (KAMs) are those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements. These include the most significant assessed of risks of material misstatement of the financial statements – including those due to fraud – that were identified by the auditor, and had the greatest effect on the overall audit strategy, the allocation of resources in the audit, and directing the efforts of the engagement team.

In determining KAMs, auditors consider identified risks of material misstatement, significant auditor judgements on financial statement line items that involved significant management judgement such as accounting estimates, and the impact of significant events and transactions during the period covered by the audit.

This snapshot details the frequency and types of KAMs for FTSE 350 and large AIM companies from our sample.

1 Frequencies of Key Audit Matters

The number of KAMs included in auditor reports varies considerably, with FTSE 100 companies having having the most. The average number of KAMs for FTSE 100 and FTSE 250 companies has declined since they were first introduced.

Figure 1 shows how the number of KAMs varied in the sampled auditor's reports. Most reports included three KAMs, but there was significant variation between reports. While several reports included many KAMs, the number of reports with only one KAM (12%) was greater than the number with six or more KAMs (10%).

There was also significant variation between companies in different market segments and industrial sectors **(Figure 2)**. Companies in the FTSE 100 had, on average, the greatest number of KAMs (4.1), followed by FTSE 250 (3.1) and large AIM companies (2.9). Banks had the most KAMs, with an average of 5.6. In contrast, financial services companies had an average of 2.4 KAMs in each report.

There has also been a decline in the average number of KAMs per report since they were introduced **(Figure 3)**. The average number for FTSE 100 companies has fallen by almost 1 KAM from 5.0 reported by the 2015 FRC report on auditor reporting to 4.1 for reports issued in 2021. A similar decline for FTSE 250 companies is also observable. Challenger firms included a similar number of KAMs as the Big 4 firms for the same market segment when it was possible to make a comparison.

Fig. 1: Numbers of KAMs in auditor reports

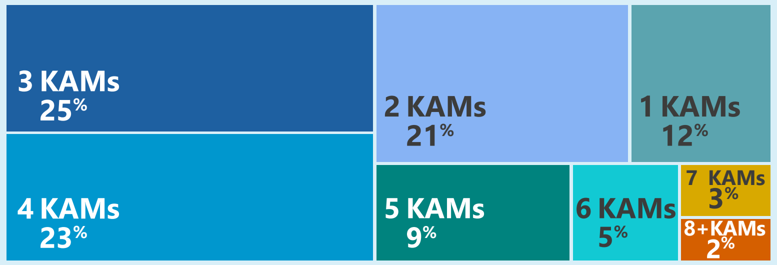


Fig. 2: Average numbers of KAMs by industrial sector and market segment

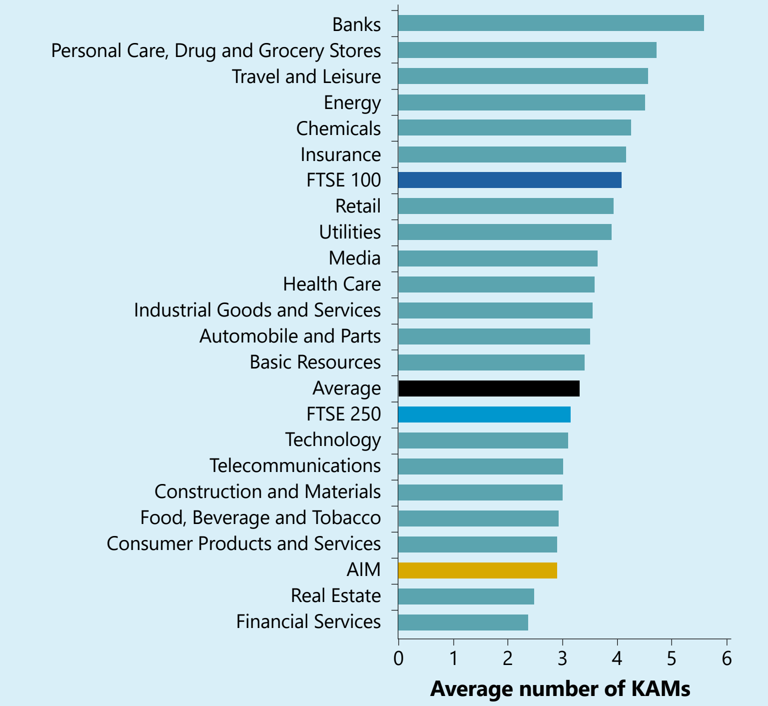
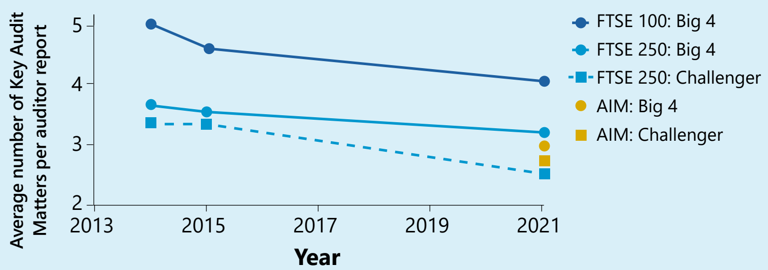


Fig. 3: Changes in the average number of KAMs



2 Types of Key Audit Matters

Figure 4 shows the frequencies of different types of KAM. Where a KAM covered more than one category, the KAM was split between these categories and given an appropriate weighting. The most common type of KAM in the current sample was revenue recognition, which is presumed as a fraud risk by the auditing standards. Other common KAMs related to financial statement line items where estimation uncertainty and management judgement created heightened risks for manipulative financial reporting. For example, investments, asset impairments, financial instruments and goodwill were all common subject matter for KAMs. In contrast, very few KAMs dealt with risks arising from non-compliance with laws and regulations. KAMs relating to COVID-19 are also common, but this was due to one audit firm including a KAM on this matter for almost all its reports (See ***Snapshot 4***).

Figure 5 illustrates how the recording of different types of KAM have changed since the previous FRC reports on extended auditor reporting issued in 2015 and 2016. This shows that the categories of KAMs have remained broadly stable since auditor reporting was introduced. Key audit matters relating to investments, going concern, and expected credit losses (ECLs) have become more common over time.

The increase in KAMs for going concern is attributable to the pandemic, while changes in accounting standards explains the growth in those relating to ECLs. KAMs on provisions and contingent liabilities, goodwill, and taxation have become rather less common since 2015 and 2016.

Figure 6 shows the difference in the reporting of certain types of KAM between different market segments. This graph shows, for a given type of KAM, how the share for a particular market segment differs to the overall share. For example, KAMs on acquisitions and disposals formed 5% of the entire sample, but 13% of KAMs of large AIM companies – a difference of 8%. Auditor's reports for large AIM companies were also more likely to include KAMs on capitalisation and development expenditure, going concern, and revenue recognition. Pensions, provisions and contingent liabilities, and taxation matters were more common for FTSE 100 companies, and financial instruments were more common for FTSE 250 companies.

Fig. 4: Frequencies of different types of KAM

Fig. 5: Changes in types of KAM over time

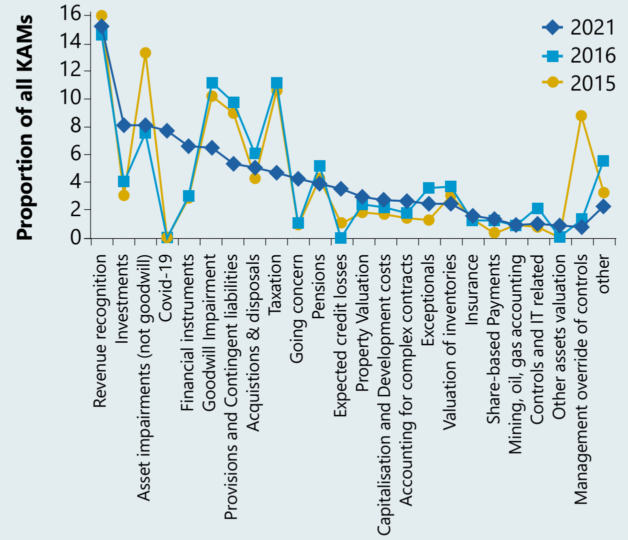
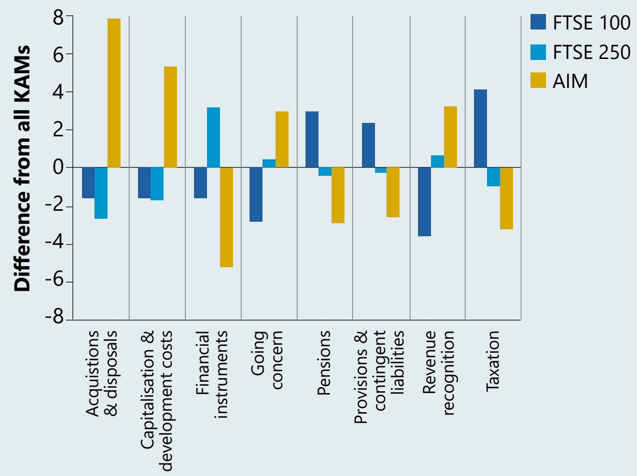


Fig. 6: Principal differences in KAMs between market segments



3 Communicating risks, procedures, and findings

Any assessment of the quality with which the auditor communicates risks, details procedures performed in response to these risks, and presents the findings of these procedures to users, is necessarily subjective. However, objective indicators of reporting quality can be used to compare different reports between different market segments and across firms. These are presented in **Figure 7**.

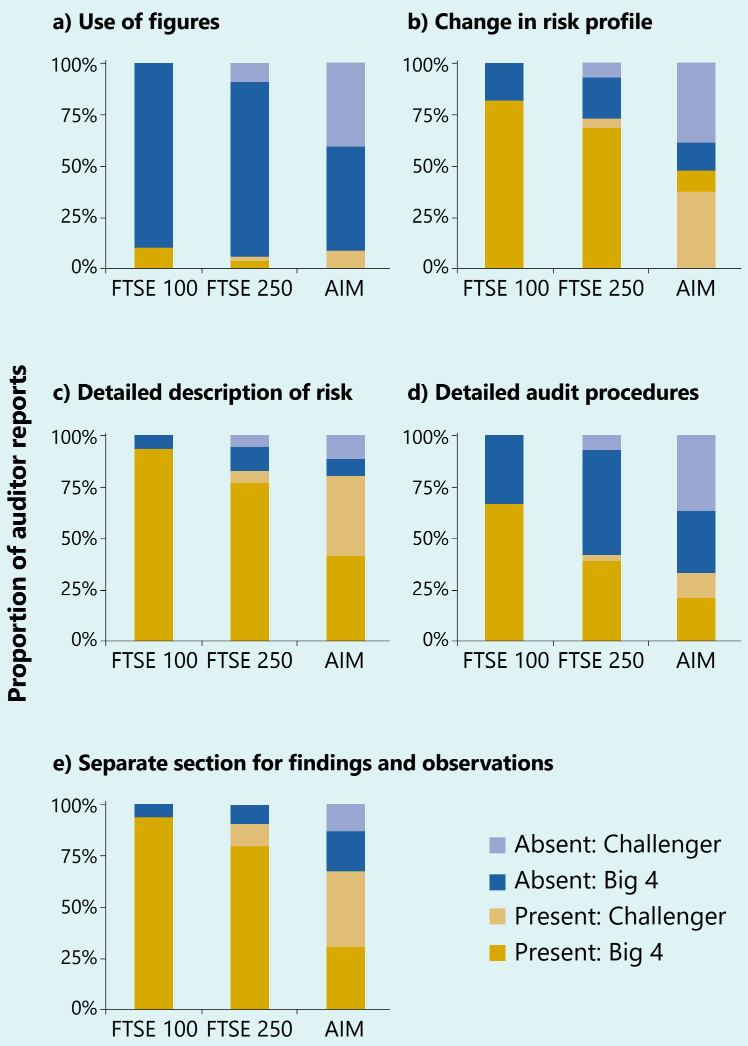
One indicator is the use of figures and other illustrations to communicate the risk discussed within a Key Audit Matter **(Figure 7a)**. The application of this approach was rare, with only 29 out of 396 reports making use of a diagram. It was marginally more common for auditor's reports issued for FTSE 100 companies, with 9% of reports making use of this approach.

A further indicator is whether a KAM informs the user on how the level of risk for this matter has changed over time **(Figure 7b)**. This information is provided for most reports within the sample. However, it was most frequently provided for FTSE 100 companies, with reports for large AIM companies being the least likely to include this detail. This is observable for both Big 4 and Challenger firms, as both groups were less likely to include this information for large AIM companies.

A similar pattern was apparent in whether a Key Audit Matter includes a detailed description of either the risk underlying the KAM **(Figure 7c)** or the audit procedures performed in response to the risk **(Figure 7d)**. Detailed descriptions of the risk were provided more frequently than an outline of the auditor's response. In both cases, this information was more likely to be provided for FTSE 100 companies, and to be provided by reports issued by Big 4 firms.

One final indicator is whether a separate section setting out findings and observations was included for each KAM **(Figure 7e)**. Again, auditor's reports issued for FTSE 100 companies were most likely to include this, and those for large AIM companies were the least likely to do so. Both Challenger and Big 4 firms were less likely to include this information for AIM companies.

Fig. 7: Quality indicators in KAM reporting

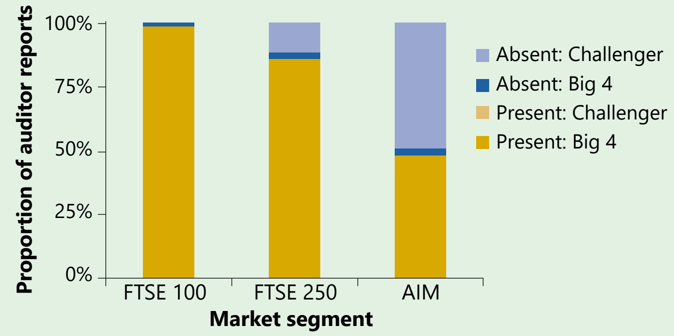


4 Key Audit Matters and the annual report and accounts

Our review considered the extent to which auditor's reports helped users identify significant and relevant disclosures within the Annual Report and Accounts.

One way of quantifying this was measuring the extent to which KAMs cross reference the relevant sections of the annual report, and in particular the financial statements. **Figure 8** compares how cross-referencing differed between different groups of firms and different market segments. Cross-referencing was almost universal in reports issued by the Big 4, though dropping off slightly for FTSE 250 and large AIM companies. In contrast, it was almost entirely absent from auditor's reports issued by Challenger firms.

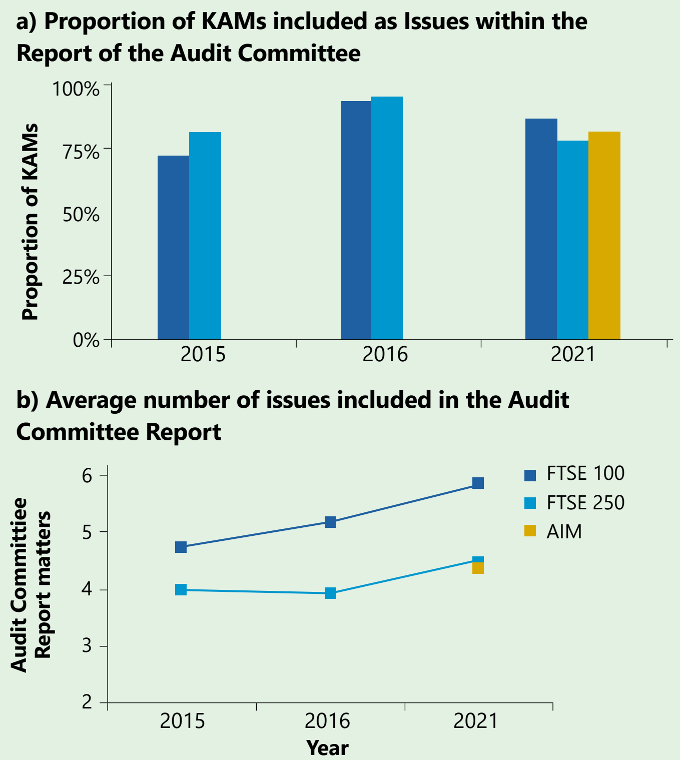
Fig. 8: Extent of cross referencing between KAMs and the annual report



We also looked at whether significant issues disclosed in Audit Committee Reports were consistent with the KAMs included within auditor's reports **(Figure 9)**. Not all AIM companies include a discussion of significant issues covered by their audit committees in their annual reports, as this is not a mandatory requirement for them. This accounts for the low proportion of issues corresponding with KAMs that were discussed within the audit committee reports for AIM companies.

However, it is possible to compare large AIM companies that report on the key issues included for the audit committee report. AIM, FTSE 100 and FTSE 250 companies are broadly comparable on this basis **(Figure 9a)**. This shows that there has been a decline in the proportion of KAMs which are also key issues in the audit committee report between 2016 and 2021. This is partly due to an increase in the number of issues disclosed in the audit committee report, which has risen from 5 to 6 for FTSE 100 companies **(Figure 9b)**. The average number of KAMs in the auditor's report has also declined **(Figure 3)**.

Fig. 9: Auditor reporting and audit committee reporting



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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Summary

- There are significant variations in the **number of KAMs** included in each auditor's report, with a reduction in the average number since the requirement to report on KAMs was introduced.
- There has been stability in the **types of KAM** since these were introduced. There are also differences between different market segments, which reflect the nature of companies in each market segment.
- The **quality indicators** for KAM reporting varied between different market segments.
- Auditor's reports frequently cross reference the **financial statements**, though the proportion of KAMs included within the report of the Audit Committee within the annual report has fallen since 2016.