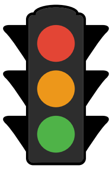
How did COVID-19 influence audit reporting?

Analysis of 2020 NZX reporters' audit reports

The impact of COVID-19 on New Zealand's companies has undoubtedly been significant. Our earlier reports outlined the likely impact of the pandemic on audit reports followed by analysis of the actual effect on March to May, June and September to December NZX50 reporters. This research revealed the consequences for financial reporting were modest with most companies addressing the challenges and making the appropriate adaptations.

In our latest report, we look at the impact of COVID-19 on audit reports across the NZX throughout 2020. How did auditors respond to the challenges and how did they communicate their findings?

> This report further highlights the importance of existing and prospective investors engaging with audit reports – and in particular the qualitative reporting by auditors in the Key Audit Matters section – to better understand the context and drivers of matters that are impacting issuers' corporate performance and financial health.
>
> **Joost van Amelsfort**
> **Chief Executive, NZ RegCo**



Our traffic light system – classifying audit reports

We have classified all 106 audit reports according to a traffic light system. We developed this system for our publication in May 2020 (How has COVID-19 affected financial reporting? Analysis of the impact on March to May NZX50 reporters) where we considered the likely scenarios we expected to see in audit reports as a result of the pandemic. The traffic light analogy was designed to easily indicate how the auditor assessed the overall outcome of the audit and where readers of audit reports should focus their attention.

For this report, we have developed this framework further to provide a more granular analysis of audit reports in the **orange** and **green** classifications. This is outlined in the table on page 3. By expanding our system of analysis we have been able to drill into greater detail about the audit reports of New Zealand companies. It has provided greater clarity about the impact of COVID-19, how local businesses weathered 2020 and the shape of financial reporting in this country.

Our research

For this study we reviewed the audit reports of 106 entities listed on the NZX Limited (NZX) for financial periods ended 1 February 2020 to 31 January 2021. The 106 entities comprise:

- Entities with a primary listing on the NZX in 2020.
- Market capitalisation greater than NZ$20 million.

Our research does not include any entities that listed on the NZX during the year and any that ceased trading during the year.

Key findings:

69%

of NZX KAMs were related to goodwill, intangible assets, valuation of assets (including net realisable value), recoverability of receivables (including expected credit losses) or property held at fair value.

11%

of audit reports included a KAM relating to funding, covenant compliance, capital requirements or liquidity management.

9%

of audit reports included KAMs NOT focused on going concern, impairment or valuation of assets.

15%

of the KAMs reported related to valuing property.

The release of financial statements including auditors' reports led to no discernible changes in share prices.

2020 audit reports by NZX reporters – the numbers

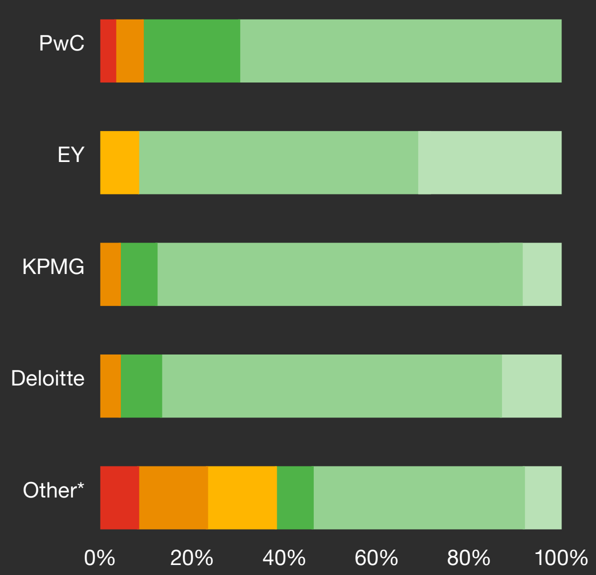
The table below categorises the audit reports of NZX reporters in 2020 using our traffic light system. It defines each category and reveals the number and percentage of audit reports that fall within it.

It reveals that of the 106 audit reports included in our research the majority (96) fell within the wider green category. In contrast, only two had a red or qualified audit opinion. Our in-depth commentary below unpicks the details of each category.

		No. of audit reports	% audit reports of total
Areas of lesser concern			
Light Green	Unqualified audit opinion with no KAMs related to impairment, goodwill, valuation or going concern matters	10	9%
Green	Unqualified audit opinion but with a KAM relating to impairment, goodwill, or valuation matters	73	69%
Dark Green	Unqualified audit opinion but with a close call KAM related to going concern considerations by the auditor	12	11%
Areas of moderate concern			
Yellow	Unqualified audit opinion but with an Emphasis of Matter not related to going concern	3	3%
Orange	Unqualified audit opinion but with a Material Uncertainty related to Going Concern (MURGC)	6	6%
Areas of most concern			
Red	Qualified Audit Opinion	2[1]	2%
	Total	**106**	**100%**

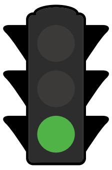
1 One entity included in the red category also has an Emphasis of Matter.

Audit reports by firm (proportional)



*'Other' includes Grant Thornton, BDO, Staples Rodway, Crowe Howarth, RSM Hayes Audit and William Buck.

What does our traffic light system reveal about audit reporting?



Green audit reports – how were Key Audit Matters (KAMs) used?

A note on KAMs

KAMs are included as a section in the audit reports of all FMC[2] entities with a higher level of public accountability. KAMs provide transparency about the matters that, in the auditor's judgement, were of most significance in the audit of the financial statements. Generally, this will represent the areas where the most audit effort was focused. KAMs are selected by the auditor from the matters communicated with those charged with governance including boards and audit and risk committees.

KAMs are normal and to be expected. The auditor uses KAMs to tell the story of their audit, especially where significant effort was needed. Users of audit reports should read KAMs as they will provide information around the key matters that the auditor focused on and will therefore provide insights into some of the risks in the financial statements.

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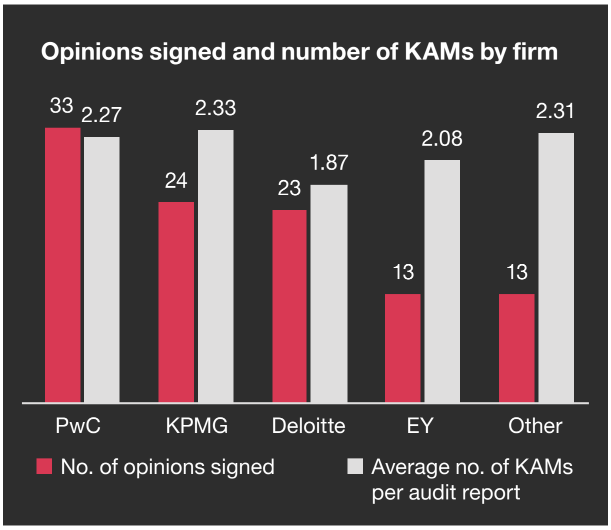

The use of KAMs in 2020 audit reports

We predicted an increase in the number of KAMs in NZX listed entity audit reports given the increased uncertainty and the judgements in the financial statements brought on by COVID-19 and this was confirmed.

In our research, we found that KAMs were changed in many audit reports to include COVID-19 clearly in the title. In some cases, the auditor identified how they had changed their audit procedures in light of the pandemic to consider its specific impacts. Some audit reports were reordered to elevate the importance of KAMs with these included earlier in the document. Bolding and italics were included within the KAM explanations to highlight significant matters believed to be more important to readers.

More KAMs were reported by auditors across the NZX listed entities. The average number of KAMs reported by firms was similar apart from Deloitte – its reports included fewer than other firms on average.

We analysed the reported KAMs and split the **green** traffic light audit reports into three categories as follows:

- **Light Green** – no KAMs related to impairment, goodwill, valuation or going concern.
- **Green** – includes a KAM relating to impairment, goodwill, or valuation matters.
- **Dark Green** – includes a 'close call' KAM related to going concern considerations by the auditor.

2 Entities as defined under the Financial Markets Conduct Act.

Light Green audit reports – no KAMs related to impairment, goodwill, valuation or going concern

10 audit reports | 9% of the total number of audit reports

Of the 106 audit reports only 10 or 9% had what we have classified as a **light green** audit report. These did not have any KAMs focused on going concern, impairment or valuation of assets.

This could be seen as a low number given the higher levels of judgement and subjectivity we have seen in financial statements arising from the International Financial Reporting Standards. These standards are heavily weighted towards valuing assets at fair value and including intangible assets on the balance sheet. Goodwill is no longer routinely amortised but is subject to an annual impairment test to determine if the balance is still recoverable.

In recent years, we have seen the introduction of the new revenue recognition and leasing standards which have also brought increased complexity to financial reporting. The leasing standard has grossed up balance sheets with the majority of leases now being included on entity balance sheets as right of use assets with an associated liability for the lease obligations arising.

Going forward, investors should look out for the new standard on accounting for insurance contracts. This is long overdue and will apply for financial reporting for 31 December 2023 year ends and onwards.

Another way to read these findings is that there is a low number of companies that have KAMs purely on matters outside of impairment, goodwill, valuation or going concern due to the impact of COVID-19.

Green audit reports – KAMs relating to impairment, goodwill or valuation

73 audit reports | 69% of the total number of audit reports

Given the prominence of fair value judgements in financial reporting, it is not surprising that over two thirds of all the NZX audit reports included at least one KAM on this matter. This is where the auditor spent significant audit effort on either impairment of an asset (whether it was intangible such as goodwill, brands or customer relationships) or on valuation of other assets such as investment property. This category also includes KAMs for insurers who must value liabilities due to policyholders under insurance contracts (i.e. claims).

We saw 33% NZX50 and 36% non-NZX50 entities with these types of KAMs. The nature of the KAMs was evenly distributed between:

- Goodwill.
- Indefinite lived intangible assets.
- Inventory valuation (including net realisable value).
- Recoverability of receivables (including expected credit losses).
- Property held at fair value.
- Valuation of financial instruments.

The challenge of property valuation

During 2020, 15% of the KAMs reported related to valuing property. While many would have had a KAM on this previously (it is often the most material asset on the balance sheet and it is required or is through a policy choice being held at fair value), COVID-19 made it a problematic area.

Valuation of investment property and other property held at fair value was challenging for March 2020 reporters. Given New Zealand was in lockdown Level 4 at 31 March 2020 there was largely a 'freeze' in property transactions. This means a lack of commercial property transaction activity on which to establish a willing buyer and seller price (fair value).

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> There were 11% (12 entities) where the auditor included a KAM relating to funding, covenant compliance, capital requirements or liquidity management.

In the absence of market evidence and a very unknown road ahead, registered valuers included caveats in their valuations to highlight that there was less certainty than normal and there was likely a larger range of possible valuation outcomes for a property. This phenomenon hadn't been seen in New Zealand (apart from in a few circumstances following the Christchurch Earthquake) in such a widespread manner before. Auditors responded by including their consideration of these caveats in their KAMs.

Since the Level 4 lockdown, there has been a resumption of commercial property transactional activity. Valuers have now largely removed these caveats from their valuation reports. However, for those assets exposed to entertainment, hospitality or retail, these caveats will likely remain.

Dark Green audit reports – KAMs relating to going concern

12 audit reports | 11% of the total number of audit reports

There were 11% (12 entities) where the auditor included a KAM relating to funding, covenant compliance, capital requirements or liquidity management. If an auditor has included this in a KAM it is generally referred to as a 'close call'. If the business had not addressed these matters this could have resulted in an **orange** audit report or one containing a "*Material uncertainty relating to going concern*" paragraph.

Interestingly, there were a similar number of dark green KAMs in the NZX50 (5%) and non-NZX50 (6%). Of the 12 entities, there were four that had a 'close-call' KAM in the prior year. This means going concern was already an item under robust consideration by the auditor even before the impact of the pandemic. These businesses were already closely monitoring their funding/capital requirements and liquidity before COVID-19 hit.

Generally, the companies in this category took action promptly to address the potential impact of COVID-19 on their business. They ensured they had the necessary financial funding and liquidity to underpin the use of the going concern basis of accounting and to stay afloat.

The common actions taken included:

- Pushing out debt repayment/covenant testing dates/ organised facilities – 10 entities.
- Capital raising/ private placement – four entities.
- Reducing cash burn – eight entities explicitly disclosed active plans to manage cash burn including suspending dividends, deferring capital expenditure and stopping discretionary spend.

  (Note: the total is more than 12 as most companies were doing a combination of these actions.)

Out of the 12 entities, five have released their most recent 2021 financial statements and the 'close call' KAMs in relation to going concern have been removed from their respective auditor's reports. This points to the resilience of these entities through the COVID-19 pandemic.

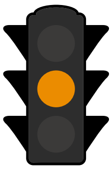
We did note some inconsistencies in what auditors reported as KAMs. Some entities had significant capital raises combined with debt repayment facility and covenant testing renegotiations that were not included as a KAM. Given the substantive multiple actions taken by some of these companies requiring attention by experienced auditors, it is surprising this was not reported as a KAM.

Yellow audit reports – emphasis of matter not related to going concern (a 'warning' traffic light)

3 audit reports | 3% of the total number of audit reports

In both of its non-NZX50 audits, one firm included an emphasis of matter paragraph (which we classify as a warning light) discussing the impact of COVID-19 on overall accounting estimates and judgements while also including a separate KAM on the same accounting estimates and judgements.

While outside our analysis, it is interesting to note, the Auditor-General included a COVID-19 emphasis of matter 'warning light' paragraph in the majority of public sector audit reports issued in 2020. This was a position taken by the Auditor-General to ensure the public were aware of COVID-19 and its impacts (or lack of) on each public sector organisation.



Orange audit reports – material uncertainty related to going concern (a ‘warning’ traffic light)

6 audit reports | 6% of the total number of audit reports

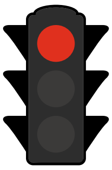
Although not a qualification of the auditor’s report, the inclusion of a section along these lines is a ‘warning light’ to the users of the financial statements. The auditor does this to draw a reader’s attention to the relevant notes in the financial statements which will explain what the material uncertainty is with respect to a businesses ability to continue as a going concern.

In 2020, we saw seven companies with an **orange** audit report. Six of these had the same material uncertainty called out by the auditor in the prior year (one was in the NZX50 and the other six were not). For the other company, the auditor hadn’t been able to form an opinion (a disclaimer was issued as noted below). We can therefore assume these entities were experiencing difficulty before the onset of COVID-19. Generally, these companies continue to incur losses and are not generating sufficient operating cash flows to meet operating costs giving rise to a dependency on future funding/capital raising to continue in business. Investors are on notice if they are investing in this type of company.

Four of the seven have now released their 2021 annual report. Two have improved to **green** audit reports with the material uncertainty related to going concern removed. It does remain in two of these reports. This means that in the last three years the auditors of these companies have highlighted there is material uncertainty related to whether the entity will remain a going concern for 12 months from the date of the auditor’s report.

What was the impact of a Red, Orange or Yellow audit report on a company’s share price?

We tracked the share price of the businesses within these categories before and after they released their audited results on the NZX, and compared them to the previous year. We found no discernible change in share price following the release of the auditor’s report. This implies the market was fully informed and had already factored in the challenges related to going concern that the auditor reported and the stocktake difficulties encountered.



Red audit reports – qualified audit opinions

2 audit reports | 2% of the total number of audit reports

As we noted in our report last year, one of the most immediate issues brought on by COVID-19 Level 4 lockdown was that many entities were unable to hold year-end stock counts at 31 March 2020. Or, if they did, the auditor was unable to attend due to Level 4 restrictions.

The auditing standards require an auditor to attend stocktakes unless it is impracticable for them to do so. If the auditor can’t attend, and can’t perform other sufficient procedures to verify that inventory physically existed at balance date, then the auditor must include what is called a “*limitation in scope*” in the audit report. This means the audit opinion is qualified.

Normally a qualified opinion would be classified as a **red** traffic light. We expected many of these qualifications given the circumstances New Zealand (and the world) was experiencing. However, this didn’t happen.

There are several reasons why. For example, there are fewer NZX entities that report at 31 March with material inventory holdings. Another possible factor is that entities and their auditors worked together to perform inventory counts as soon as New Zealand was in Level 3. Given that inventory movements had been low for many companies during the Level 4 lockdown, this gave the auditor an opportunity to perform a count at a later date and perform procedures to “roll-back” to 31 March. In some situations, new technologies such as drones or video calls were used to verify inventory existence from afar – therefore avoiding a qualification.

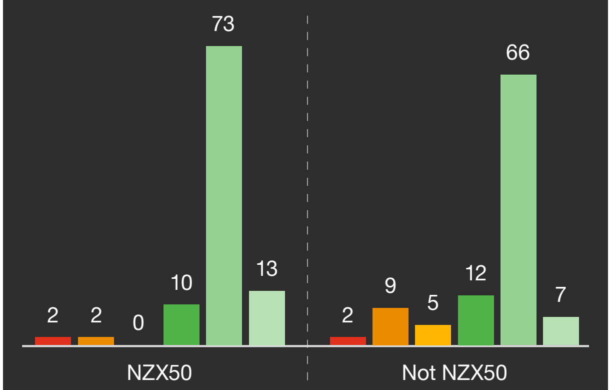
We found two entities with qualified audit reports. One company had its 31 March 2020 audit report qualified due to the auditor being unable to attend physical inventory counts in locations around the world. These counts either were not held or there were concerns about the risk of contamination to products if the count went ahead.

The other **red** audit report was a small non-NZX50 entity. This qualification related to the current auditor not being able to obtain sufficient appropriate audit evidence over the opening carrying value of an investment in an associate. In the prior year, a different auditor had issued a disclaimer of opinion (which means the auditor couldn’t form an opinion because the issues were material and pervasive to the financial statements). It is worth noting this audit report also contained what we describe as an **orange** traffic light. The auditor called out that there was a material uncertainty related to going concern.

Audit reports in and outside the NZX50

The traffic light classification can be used to compare those in and out of the NZX50. Surprisingly there is no discernible difference between the traffic light proportions between these two groups.

Opinion type NZX50 vs not NZX50
Proportion of opinions (%)



KEY

Light Green	Unqualified audit opinion with no KAMs related to impairment, goodwill, valuation or going concern matters
Green	Unqualified audit opinion but with a KAM relating to impairment, goodwill, or valuation matters
Dark Green	Unqualified audit opinion but with a close call KAM related to going concern considerations by the auditor
Yellow	Unqualified audit opinion but with an Emphasis of Matter not related to going concern
Orange	Unqualified audit opinion but with a Material Uncertainty related to Going Concern (MURGC)
Red	Qualified Audit Opinion

What did the 2020 audit reports tell us?

The impact of COVID-19 on financial reporting

While the impact of the pandemic on New Zealand's companies was undoubtedly significant, the effect on financial reporting has been modest. Our research reveals that companies and their auditors responded to the challenges and adapted their financial reporting accordingly. This is true across both NZX50 and non-NZX50 companies.

How did auditors respond?

Auditors responded to the significant impacts of COVID-19 on financial reporting by ensuring their audit reports told the story of their work conducted during such an unprecedented time. They did this in a number of ways including clearly noting how they changed their audit procedures and by amending the layout of reports, combined with the use of headings and graphics. This was done to help readers focus on the key areas that matter most in understanding financial reports.

Our research shows that KAMs were used widely across the NZX companies. Auditors included many new KAMs in their audit reports highlighting areas where significant effort was required and drawing the readers' attention to areas of key risks in the financial statements. This included consideration of the appropriateness of using the going concern basis of accounting, a change from the prior year. Clearly an area of focus due to the impact on liquidity from COVID-19.

The importance of audit reports

Our research clearly shows that there is a depth of information in audit reports. If you take the time to read them and look for the signposts the auditor has left, often establish – what areas the auditor has spent considerable audit effort on and the judgements and estimates that may be more susceptible to a larger value shift.

We continue to encourage savvy investors to use audit reports to help them frame questions for Directors at Annual Shareholders Meetings and, in doing so, bring greater transparency to financial reporting.

> This is a very useful and relevant analysis because it explains current issues about audit reports clearly. It provides financial report users with background material to help them understand and compare audit reports with others issued during the pandemic. It was useful to know that the outcome for companies outside the top 50 was similar to that for larger companies.
>
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This report follows our four earlier papers looking into the likely impact of the pandemic on audit reports followed by analysis of the actual effect on March to May, June and September to December NZX50 reporters.

Contact us

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