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Do Financial Statement Auditors Recognise ESG-Related Aspects as Key Audit Matters?

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Abstract

One of the recent trends in ESG (which stands for Environmental, Social, and Corporate Governance) is an attempt to combine sustainability and financial reporting through direct references to financial statement figures (cf. the ED IFRS S1, S2, the CSRD). This article aims to verify whether it is possible. For this reason, it was assumed that Key Audit Matters (KAMs) identified by financial statement auditors might be a valuable source of information. Identification of ESG-related KAMs by auditors may prove that ESG information is directly traceable to a financial statement and, thus, quantifiable. The empirical part was based on 142 audit reports on the consolidated financial statements for 2021. The sample focused on ESG-related capital groups with the parent entity listed on the Warsaw Stock Exchange. 292 KAMs were obtained, among which 38 (13.01% of the sample) were identified as ESG-related (32 Environmental, 1 Social, and 5 Governance). This research paper: (1) confirms that it is possible to link ESG matters and their outcomes directly to financial statement categories, (2) shows that some areas could be more challenging to quantify, for example, social or governance aspects which may not be seen directly as a financial statement category, (3) comments on KAMs as a good information source if well-written. The article underlines that any attempts to combine sustainability and financial reporting might be demanding. The ESG-exposed businesses are privileged here as their financial statements naturally present ESG-related categories. However, it raises further questions about the presentation, comparability, and integrated reporting quality of all entities, which will have to consider financial and ESG linkages in the future. This article does not answer these questions, is limited to the perspective of KAMs, and, thus, touches only on identified financial statement categories. The article, with its findings, may be important to standard-setters, companies, and other researchers contributing to ESG, financial reporting, and financial audit.

Key words: *ESG; financial statement; key audit matters; IFRS S1; IFRS S2; CSRD;*

JEL Classification: *M48, K2, Q56*

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Nowadays, sustainability reporting is one of the critical topics researchers and professionals discuss. It aims to provide a set of non-financial information, including corporate involvement in ESG, which stands for Environmental, Social, and Corporate Governance matters. Despite a magnitude of ESG-related aspects (such as proper identification, measurement, and presentation), there is also an interesting attempt to link sustainability reporting with financial statements, meaning to look for the financial implications of ESG activities.

For example, the Corporate Sustainability Reporting Directive (the so-called CSRD), which was finally published in the Official Journal of the EU on December 16, 2022[2], assumes five reporting areas: (i) business model; (ii) policies, including due diligence processes implemented; (iii) the outcome of those policies; (iv) risks and risk management; and (v) key performance indicators relevant to the business. Where applicable, the information should contain references to the other information included in the management report and figures reported in the annual (consolidated) financial statements (CSRD, Article 19a, 29a).

Two Exposure Drafts (EDs): IFRS S1 – *General Requirements for Disclosure of Sustainability-related Financial Information* and IFRS S2 – *Climate-related Disclosures,* present a similar tone. In a nutshell, a reporting entity should identify significant sustainability- and climate-related risks and opportunities and reveal how they have affected the most recently reported financial statements and how the figures are expected to change over time (ED IFRS S1, pp.22,27; ED IFRS S2, pp. 32,37).

It opens a fascinating discussion with the primary research question:

[Research Question]: Is it possible to link ESG matters and their outcomes directly to financial statement categories?

Let us begin with the fact that many researchers support the view that ESG activities cause a financial impact. Some scholars discuss ESG in light of the so-called 'value creation' (e.g., Henisz, Koller and Nuttall, Zumente and Bistrova, 2021; Glassman, Potoski and Callery, 2017). Some studies confirm an ESG impact on a firm value (e.g. Fatemi, Glaum and Kaiser, 2018; Yoon, Lee, and Byun, 2018, Aydoğmuş, Gülay, and Ergun, 2022). Some studies relate to an ESG impact on financial performance (e.g. Velte, 2017; Ahmad, Mobarek, and Roni, 2021; Hwang, Kim, and Jung, 2021).

The results of the research studies provide a general understanding that ESG matters may be treated as factors leading to the financial implications of different types. However, they do not say much about financial statement categories and the ESG impact, which could be recognized directly by financial statement users.

Identifying and quantifying the impact of ESG factors concerning particular financial statement figures will be challenging for several reasons. Firstly, there are ESG risks and opportunities of different natures, which may not have a direct economic impact, or this impact may be difficult to assess.

Secondly, assuming ESG risks and opportunities have an impact on a financial statement, there is uncertainty about how this impact should be reported. Will a single or cumulative number say anything? Should it be instead presented as a percentage of a particular financial statement category? Should it be directly verifiable in a financial statement?

Finally, if a reporting entity provides references to the figures reported in the annual financial statements, what should be the response of a statutory auditor? On the one hand, such information should be considered in respect of ISA 720 – *The auditor's responsibilities relating to other information and related conforming agreements.* On the other hand, obtaining assurance on ESG data is not currently part of a financial statement audit. ESG engagements may be classified under International Standard on Assurance Engagements (ISAE) 3000 (i.e., engagements other than audits or reviews of financial statements). Moreover, the IAASB is working on the International Standard on Sustainability Assurance (ISSA) 5000 – *General Requirements for Sustainability Assurance Engagements*.

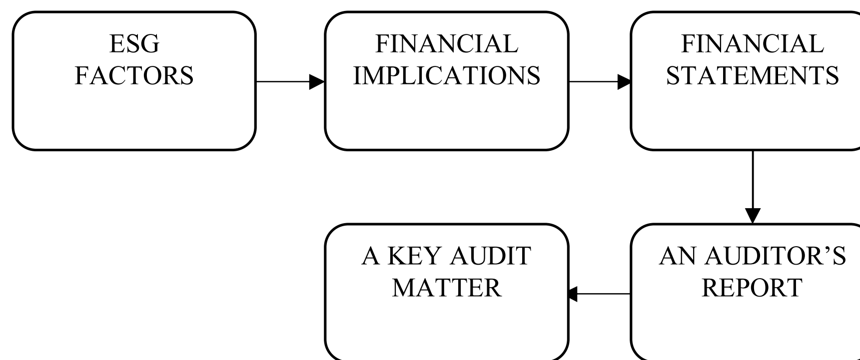
With so many question marks, I proposed a construct to address the significant concerns mentioned above (***Figure no. 1***). Assuming ESG factors have financial implications, they should be reflected, to some extent, in a financial statement, which is further examined by an

[2] The CSRD will be applicable for the first time in 2025 for the financial year 2024 and will relate to companies already subject to the Non-Financial Reporting Directive (NFRD). Subsequently, large companies (not subject to the NFRD) will provide sustainability reporting in 2026 for the financial year 2025.

independent auditor (if specific requirements are met). Under ISA 701, an auditor must issue an audit report which includes (apart from an audit opinion) the so-called Key Audit Matters (KAMs), i.e. areas that auditors recognize during an audit as high risk of material misstatement. Identifying ESG-related KAMs would confirm that ESG matters may be linked directly to financial statement categories.

Based on this construct, the article is organized as follows. Section 1 presents the literature review and justification for why ESG-related aspects may be recognized as KAMs in the audit report. Then, the theoretical assumptions were confronted with the empirical research. For this reason, Section 2 presents the sample selection methodology. I collected audit reports for 142 ESG-related capital groups with the parent entity listed on the Warsaw Stock Exchange. The collected audit reports were a source of 292 KAMs. Section 3 includes an analysis of the collected sample and the results. Finally, Section 4 presents conclusions, whereas Section 5 – is a discussion.

Figure no. 1. The construct of the article



Source: Own elaboration

This research paper confirms that it is possible to link ESG matters and their outcomes directly to financial statement categories. Moreover, financial auditors may recognize ESG-related aspects as KAMs, especially in the case of ESG-exposed businesses.

Out of 292 KAMs, 38 were captured as ESG-related (13.01% of the sample): 32 Environmental, 1 Social, and 5 Governance (Section 3). These KAMs, when well-written, may become a reliable source of ESG-related information confirmed by an auditor during an audit and directly traceable to a financial statement. However, the results deliberately showed that some areas could be more challenging to quantify, for example, social or governance aspects and may not be seen directly as a financial statement category. The study's results underline that any attempts to combine sustainability and financial reporting might be challenging and complex in many aspects.

Finally, the sample revealed that KAMs are often standardized and technical. Many readers may find them unreadable due to focusing on an accounting approach without saying much about details (for example, the nature of the discussed assets or revenues).

1. The literature review

According to Article 10 of the EU Regulation 537 (2014), the audit report should include a description of the most significant assessed risks of material misstatement and a summary of the auditor's response to those risks. Moreover, ISA 701 requires auditors to communicate Key Audit Matters (KAMs), i.e. *Those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period* (ISA 701, point 8). Such matters may involve: (a) areas of higher assessed risk of material misstatement, (b) significant auditor judgments resulting from significant management judgment, and (c) significant events or transactions (cf. ISA 701, point 9).

Despite being a mandatory requirement, the role of a KAM has been expanded beyond just fulfilling this requirement. First, many scholars examine the informative value of

KAMs, meaning the consequences of KAM disclosures. For example, a review of the academic literature by Gold and Heilmann (2019) reveals four main areas: (1) investor behavior and market reaction, (2) auditor responses (such as audit fees, audit quality, or audit delay), (3) auditor liability, and (4) client management responses. Although the results of the studies are mixed, KAMs may be treated as a communication channel.

Second, some researchers concentrate on the factors influencing the number of reported KAMs. For example, the results presented by Wuttichindanon and Issarawornrawanich (2020) associate the number of KAMs with the auditor's litigation risk, firm complexity, profitability, and industry type. Pinto and Morais's (2019) findings show that a higher number of business segments (complexity) and more precise accounting standards lead to the disclosure of a higher number of KAMs. Ferreira and Morais (2019) confirm a positive relationship between the number of KAMs disclosed and both the auditor being a Big4 and the complexity of the audited company. Verho (2021) states that companies with audit firm rotation report more KAMs than companies without rotation.

Third, a small group of researchers analyses the content of KAMs. For example, Abdullatif & Al-Rahahleh (2020) mention the following KAM groups: accounts receivable, inventory, investment property, and revenue. The authors notice that audit firms tend to report industry-specific KAMs rather than entity-specific ones. Li (2020), among the top five KAM topics, refers to revenue recognition, accounts receivable allowance, goodwill impairment, inventory write-down, and PPE impairment.

Finally, I spotted a scientific nichè, i.e. only a few scholars discuss specific KAMs. For example, Sneller, Bode, and Klerkx (2017) analyze IT-related KAMs, proving that KAMs may be a valuable source of information for an area hardly discussed elsewhere. Lynch, Mandell, and Rousseau (2021) focus on tax-related KAMs, examining the relationship with the purchase of auditor-provided tax services. Honkamäki, Mättö, and Teittinen (2022) focus on KAMs and the fair value of investment properties, examining the homogeneity of Big-4 audit reports in this area. Rainsbury, Bandara, and Perera (2022) use the circumstances of the COVID-19 pandemic and attempt to capture audit procedures explicitly related to the COVID-19 audit risks.

Considering all the above, there is an excellent research opportunity to analyze ESG-related matters from the KAM perspective. On the one hand, KAMs are widely used as an information and communication channel. On the other hand, as mentioned in the introduction, ESG activities have financial potential and may positively impact financial performance or firm value. Consequently, they may affect financial statement categories such as revenues, tangible assets, or inventory, which are also of high auditor focus. For this reason, the following hypothesis has been formulated:

[H]: ESG-related aspects may be recognized as Key Audit Matters in the audit report.

Confirmation of this hypothesis will have significant benefits. KAMs may become a reliable source of ESG-related information examined by an auditor during an audit. If so, we receive information directly traceable to a financial statement and, thus, quantifiable. Finally, ESG-related KAMs may confirm that a company is involved in ESG.

2. The empirical research methodology

The hypothesis verification required collecting the audit reports. The population was determined based on the number of companies listed on the Main Market of the Warsaw Stock Exchange (WSE) (418 as of October 2022). Two criteria have been applied: (1) a company represents an ESG-related sector, and (2) a company is a parent entity of a capital group. All reports are related to the financial year 2021.

The first criterion enabled to identify 190 companies which were divided into three groups:

- Group A: the riskiest sectors according to the ESG Risk Atlas (2019, p.3), i.e., Oil and Gas, Metals and Mining, Power Generation (coal), Refining and Marketing, Chemicals, Technology Hardware and Semiconductor, Power Generation (excl. coal), Autos and Auto Parts, Agribusiness, and Commodity Foods;
- Group B: innovative sectors such as Biotechnology, Land and Water engineering, New Technologies, Recycling, and Renewable Energy;
- Group C: other potentially related: Paper and Packages, Plastics, Construction, Construction Materials, IT Software, IT systems.

The second criterion reduced the sample to 142 capital groups with a parent entity listed on the WSE

(see Table no. 1). Capital groups have been selected for three reasons. First, some scholars confirm a positive relationship between the number of KAMs and firm complexity (see Section 1 for examples) – the more KAMs, the greater the chance to capture specific KAMs, such as ESG-related. Second, capital groups give a broader view than a single entity, which may be crucial in the case of aspects like ESG. Third, the auditor reports on consolidated financial statements are expected to include more KAMs than the auditor reports on statutory financial statements.

Table no. 1. The structure of a selected sample

Sector	No. of capital groups
Group A	
Agribusiness and Commodity Foods	15
Automotive and Transport	11
Chemicals	7
Metals and Mining	19
Oil and Gas	2
Power Generation	9
Technology Hardware and Semiconductor	7
Group B	
Biotechnology	5
Land and Water engineering	6
New Technologies	2
Recycling	4
Renewable energy	3
Group C	
Construction	15
Construction materials	11
IT Software	14
IT Systems	8
Plastics	2
Paper and Packages	2
Grand Total	**142**

Source: Own elaboration

3. The empirical research results

First of all, it was worth examining the main groups of KAMs in the selected sample, which consisted of 142 audit reports that yielded 292 KAMs. In the justification for the KAM selection (apart from the significant risk), the auditors mentioned the substantial value of a particular financial statement category, industry/business specificity, or important one-off transactions taking place in an audited financial year.

The five most common groups of KAMs in the examined sample were:

- **Revenues** – 85 KAMs (29.11%);
- **Tangible and Intangible Assets impairment** – 55 KAMs (18.84%);
- **Goodwill impairment** – 31 KAMs (10,62%);
- **Inventory measurement and impairment** – 23 KAMs (7.88%);
- **Substantial transactions** (such as the purchase or sale of shares) – 12 KAMs (4.11%).

The KAMs mentioned above were expressed in accounting terms and were often relatively standardized and technical. However, the examined sample revealed 38 specific KAMs (13.01% of the sample), which addressed ESG aspects.

First, matters related to the "Governance" component of ESG were straightforward because of the financial audit character. To some extent, all KAMs may be treated as Governance-related as they address the areas of high risk of material misstatement, which, in turn, are related to the internal control system. Five KAMs in the examined sample explicitly dealt with corporate governance, for example, with: (1) the risk of management bypassing internal controls because the President of the Company's Management Board is also the main shareholder in the Company; or (2) the determination of effective control based on the number of shares under specific circumstances. In one specific case, the auditors issued a disclaimer of opinion proving the deficiencies in the financial reporting process and the group's management not maintaining an adequate system of internal controls.

Second, when it comes to the "Environmental" component, it was not directly exposed, meaning auditors did not discuss an environmental risk as part of an audit risk separately. However, it does not mean that the environmental aspects were absent. If the capital group represents an ESG-exposed business (specifically from sectors listed in Group A), then ESG factors are embedded into financial statements. Consequently, KAMs may reflect on these matters directly. Unfortunately, it turned out that some KAMs are general and unreadable without details from a financial statement, meaning the auditors use technical language which focuses on describing an accounting approach without saying much about the nature of the discussed assets, inventory, or revenues, or unique/industry-specific/firm-specific factors having an impact on a write-down.

Nevertheless, 32 KAMs were specific enough to capture environmental aspects in the following areas:

- **Fixed assets impairment** in three sectors: Metals and Mining, Paper and Packages, and Power Generation (11 KAMs);
- **The valuation of biological assets** (6 KAMs);
- **Inventory impairment** (4 KAMs);
- **Valuation and completeness of provisions** for mine decommissioning costs, mining damage, and other environmental risks (3 KAMs);
- **Revenues** from the sale of copper, silver, gold, petrochemical products, and electricity; revenues derived from waste management (3 KAMs);
- **Classification and valuation of commodity contracts** (such as electricity, gas, emission allowances, oil, and coal) (2 KAMs);
- **The valuation of a photovoltaic power plant** (1 KAM);
- **Litigation and contingent liabilities** (1 KAM);
- **Substantial compensation due to the legal act** (1 KAM).

There are several observations here. Well-written KAMs listed above may be a valuable source of ESG information for audit report readers. The critical point is that these aspects are directly linked to a financial statement, meaning they are measurable and audited by an auditor. Moreover, these KAMs provide a snapshot of the business sensitivity to factors like changes in crude oil and natural gas prices, emission costs, technology, or legal environment which may affect the impairment calculation, revenue streams, liabilities, and other financial statement categories.

Third, the "Social" component was practically absent. Only one KAM was identified in this area and addressed provisions for employee benefits.

The results presented in this section prove that the construct proposed in the beginning (***Figure no.1***) is correct. We can expect ESG factors, which lead to financial implications and affect a financial statement in various categories. However, the results deliberately showed that some areas could be more challenging to quantify, for example, social or governance aspects. These areas are essential to guarantee a harmonized business organization but may not be seen directly as a financial statement category. Therefore, ESG factors may be divided into: (1) having an impact on a financial statement or not, and if yes, (2) having a direct impact on a financial statement or indirect.

4. Conclusions

This research paper confirms that it is possible to link ESG matters and their outcomes directly to financial statement categories. Moreover, financial auditors may recognize ESG-related aspects as Key Audit Matters (KAMs). However, several points should be emphasized based on the empirical results.

First, as a response to the ED IFRS S1, S2, and the CSRD, quantifying the ESG impact on a financial

statement is possible. If we discuss an ESG-exposed business (specifically from sectors listed in Group A), the financial statement will easily present ESG-related assets, liabilities, revenues, and other categories. In this case, concerning the ED IFRS S1 and S2, it should not be problematic to determine the outcome of various ESG risks and opportunities as management should perform such assessments, for example, for impairment calculation or evaluation of going concern. In the end, ESG should be directly verifiable in a financial statement. At the same time, ESG quantification for businesses not directly involved in ESG may be challenging.

Second, this research paper refers to KAMs. It is a popular topic among researchers due to its information potential. The sample revealed that KAMs are often standardized and technical. Many readers may find them unreadable due to focusing on an accounting approach without saying much about details (for example, the nature of the discussed assets or revenues).

Nevertheless, 38 specific ESG-related KAMs (13.01% of the sample) were identified: 32 Environmental, 1 Social, and 5 Governance (see Section 3). These KAMs, when well-written, may become a reliable source of ESG-related information confirmed by an auditor during an audit and directly traceable to a financial statement. However, the results deliberately showed that some areas could be more challenging to quantify, for example, social or governance aspects, and may not be seen directly as a financial statement category.

Finally, the study's results underline that any attempts to combine sustainability and financial reporting might be challenging and complex.

The future will show how the entities will approach the concept of integrated reporting in practice. Will we see an expanded report with multiple direct references to a financial statement or a sustainability report in its current form with only a few vague linkages to financial reporting? Will we receive meaningful, quantifiable information or rather descriptive explanations? These question marks may become a research opportunity in the future, for example, regarding (1) presentation and comparability of the integrated information, (2) integrated reporting quality, or (3) the financial statement auditors' response.

This research study faces several limitations. First, capturing ESG-related KAMs was subject to our judgment as a closed catalogue of ESG does not exist. Second, the analysis was limited to KAMs selected by auditors, and their number is usually small. Third, the sample concentrated on ESG-related capital groups with the parent entity listed on the Warsaw Stock Exchange. The time frame was limited to the financial year 2021. Changes in the research methodology could impact the final results.

5. Discussion

The article touches on many themes. The topic of ESG financial implications has already been widely discussed. However, the expectation of a direct interrelation between sustainability and financial reporting is another story. The CSRD was finally published not long ago – in December 2022. The IFRS S1 and S2 are currently in the form of Exposure Drafts, and the standard-setters will issue final standards as early as possible in 2023. The number of *ex-ante* empirical studies in this aspect is limited. This article presents a somewhat skeptical view as the companies might not be prepared in reporting systems and processes compared to the pace of regulatory proposals. In addition, Pratama, Jaenudin, and Anas (2022) examined companies in Southeast Asia regarding disclosure requirements proposed in the ED IFRS S1, confirming that some disclosures are already made in the annual reports, but not all. The authors highlighted a difference between the extent and quality of the disclosures among countries and industries.

This article concentrates on the role and importance of KAMs. Regarding the five most common groups of KAMs identified in the sample, the results are similar to Abdullatif and Al-Rahahleh (2020) and Li (2020), which may suggest a standardized approach used by auditors in capturing KAMs. Similarly, to Sneller, Bode, and Klerkx (2017) (IT aspects) or Lynch, Mandell, and Rousseau (2021) (Tax aspects), this article aimed to capture a specific impact; however, the research studies with a combination of KAMs and ESG were not identified.

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