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The consequences of key audit matters on investor: a review

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Abstract — There is a information gap between what users expect on an audit and what an audit is, and the new audit report is made to reduce this information gap, by changing the structure and content of the audit report. Among other changes, the new audit report includes a new section for the disclosure of key audit matters (KAM) which is mandatory in Union European (UE) on June 2016 and in the United States (US) on June 2019. This change, triggered by manly the 2008 crisis, is expect a positive effect on audit quality or users' perception of it. The main objective of this paper is review the literature of this recent topic on the perspective of investor and market reaction. The results of the influence of disclosure KAM in the audit report on users and market reaction are mixed. Some and experimental studies in Canada and in the US settings, on investors and financial analysts, find a positive influence of disclosure KAM on the audit quality perception, which is not find in German setting on bank directors. When it comes to archival papers, there is not found any investor reaction to disclosure KAM.

Keywords – KAM, audit quality, audit report.

I. INTRODUCTION

The auditor has been criticized since the bankruptcy of Enron, Adelphia, Xerox and Worldcom in the United States (US), and Ahold and Parmalat in Europe for not detecting or communicating distortion on the financial statements, as well the auditor's report, mainly because it is viewed as a pass/fail report (Church, Davis & McCracken, 2008; Mock, Bédard, Coram, Davis, Espahbodi & Warne, 2013). The audit report is the main form that the auditor has to communicate information to the users of the audit to financial statements (IAASB, 2013). However, the previous audit report was viewed as highly standardized and so insufficiently useful (Church et al., 2008). It has been questioned the sufficiency of the audit report (Mock et al., 2013). For the International Audit and Assurance Board (IAASB) (2013) the main parties that benefits by the changes in the audit report will be the investors, analysts and other users, and changes made in the audit report may have positive benefits to audit quality or users' perception of it, and thus the main objective of this paper is to review the literature that examines the impact of changes in the audit report on the users' perception. Furthermore, even being audit a way to reduce agency costs, it still exists an information asymmetry between auditors and users of audit report, since the former has information that the user has not (Antle, 1982). This information asymmetry between the auditor (agent) and the user (principal) could be reduced by the auditor providing more

information to the principal enhancing the audit report (BooLaky & Quick, 2016).

The changes needed on the audit report began to be felt afterward the 2008 crisis, when the regulators, standard setters and the investors started questioning the informative value of the audit report (Asare & Wright, 2012). Mock at al. (2013) say that there is a gap between users' expectation on an audit and what an audit effectively is, being a communication and information gap. And particularly, the 2008 financial crises pointed out the limitations of the existing report, increasing the urgency to change it (Prasad & Chand, 2017). Knowing this, it was adopted by the European Union (EU) the Regulation No. 537/2014 of the European Parliament and the Council in April 2014 to improve audit quality and the IAASB, the Public Company Accounting Oversight Board (PCAOB) and the Financial Reporting Council (FRC) have finalized their projects to reinforce the usefulness of the audit report (Gold & Heilmann, 2019). The main changes on the audit report were the inclusion of key audit matters (KAM) for listed companies, beyond prominent placement of the auditor's opinion and other entity-specific information, reporting on going concern and reporting on other information. These changes are to be applied on EU for the periods beginning on or after 17 June 2016 (EU, 2014).

In changing the audit report by requiring the disclosure of the KAM the IAASB expects a positive effect on audit quality or users' perception of it, as well as an increase on the audit and financial reporting quality. The interest of users in disclosure of key areas of risk on audit report was already showed by Vanstraelen, Schelleman, Meuwissen and Hofmann (2012) stand out the importance of KAM. Providing more transparency about how the audit was performed (adding KAM) the communicative value of the auditors' report could be enhanced (Bookaly & Quick, 2016).

Due to the importance of the audit report, since it is used to communicate audit information to users, and the main user of the audit information is the investor, I intent to provide an overview and research synthesis of the emerging published studies which examine the impact of the KAM on the users' perception of audit quality.

This paper is important by providing in this recent topic of audit literature a state of art to understand what has been done so far and what are the results. Secondly, the audit report being so important and dramatically changed, it is expected that influences the audit quality or the investor perception of that

audit quality, being necessary to assess the merits of the new audit report model. Thirdly, by knowing what was done we can detect new research questions and methodologies on the topic.

The paper proceeds as follows. First, I provide an overview of the development on audit report by the most important audit standard setters and regulatory bodies. In the next section I summarize the studies on the influence of the KAM on users' perception of audit quality. In the final section I present the conclusions and possible future research.

II. AUDIT BACKGROUND

The 2008 crisis was the trigger to the audit standard setters beginning to change audit standards. However, already in 2006 the IAASB and the Auditing Standards Board (ASB) of the American Institute of Certified Public Accountants (AICPA) asked to academic research to provide insights on user's perception on audit and auditor report being those research studies finished in 2009. All these initiatives were taken to enhance the communicative value of the audit report.

A. In an international level

In May 2011 the IAASB issued a consultation paper (CP), *Enhancing the value of auditor reporting: exploring options for change*, to improve the communicative value of the auditor report by changing structure and content of the auditor report (IAASB, 2011). Afterwards, and in July 2013 IAASB issued an exposure draft (ED), *Reporting on audit financial statements: proposed new and revised International Standards on Auditing (ISA)*, proposing a new ISA for KAM (ISA 701) and revising four ISA to improve the auditor's report on audited financial statements, namely adding to the audit report the communication of KAM, as well as of the going concern issue and changing the form and content of the audit report (IAASB, 2013). The project was finished by the IAASB in January 2015 when were released the new ISA 701, as well the revised ISA 700 (Revised) on forming an opinion and reporting on financial statements, ISA 570 (Revised) on going concern, ISA 705 (Revised) on modifications of the opinion, and ISA 706 (Revised) on emphasis of matter paragraphs, to be applied for periods ending on or after 15 December 2016 (IAASB, 2015).

The main change of the IAASB's project and mandatory for listed companies are a new section in the audit report to communicate KAM. KAM are those matters which are more significant for the auditor's judgment, such as areas of higher assessed risks of material misstatement, areas in financial statements involving significant management judgement (including estimates) and the effect on the audit of significant events. Furthermore, is mandatory for listed companies the disclosure of the name of the engagement partner. Other changes, and mandatory ones for all audits, are to present the opinion section first followed by the basis for opinion section. Moreover, the auditor has to add a separate section when a material uncertainty about going concern exists as well an affirmative statement about the auditor's independence and fulfilment of relevant ethical responsibilities, with disclosure of the jurisdiction of origin of those requirements. The last change is enhanced description of the responsibilities of the auditor and key features of the audit.

The answer of the EU to the shortcomings in the audit made aware of with 2008 financial crisis was the released of the green paper *Audit policy: lessons from the Crisis*, questioning the role of the statutory audit. To improve audit quality in public-interest-entities (PIE) the EU issued in April 2014 the Regulation No 537/2014, and to enhance the single market for statutory audits issued at the same date the Directive 2014/56/EU, both by the European Parliament and of the Council, which came into effect for accounting periods beginning on or after June 2016. The main provisions included in the Regulation and Directive were the prohibition and capping of non-audit services, mandatory firm rotation, auditor reporting (namely a description of the most significant assessed risks of material misstatement, which is similar to one type of KAM), new definitions (example of PIE), independence and objectivity, quality assurance and adoption of ISA.

B. In a country level

In US the PCAOB concerned about the lack of relevance of the audit report began a project to change the form and content of the audit report (PCAOB, 2011). In 2013 the PCAOB released a proposed new auditing standard to change the audit report, proposing the communication of critical audit matters (CAM) (the same as KAM), the addition on the audit report of elements related to auditor independence, auditor tenure, and the auditor's responsibilities, and enhancements to existing language in the auditor's report related to the auditor's responsibilities for fraud and notes to the financial statements (PCAOB, 2013). In 2017 the PCAOB issued a new auditing standard (AS 3101) requiring among other things proposed in 2013 the communication on the audit report of the CAM, and this provision is to be effective for fiscal years ending on or after 30 June 2019 in the case of large accelerated fillers and 15 December 2020 for other companies (PCAOB, 2017). Furthermore, the PCAOB requires an opinion of internal control or in the audit report or in a separate report (Prasad & Chand, 2017).

One of the first countries to require disclosure of the KAM (the one related to risks of material misstatements) was the United Kingdom (UK) through publication in 2013 of ISA 700 (UK and Ireland) by the Financial Reporting Council (FRC), mandatory for audits of financial statements for periods beginning on or after 1 October 2012, and for companies with a premium listing of equity shares on London Stock Exchange (LSE) (FRC, 2013; Gutierrez, Minutti-Meza, Tatum & Vulcheva, 2018). This change in the audit report requires a description of risks of material misstatement (one of possible KAM), determination of materiality and explanation of audit scope. In 2016 the FRC published ISA 701 (UK and Ireland) based in IAASB's ISA 701 required for audits on or after 17 June 2016 (FRC, 2016).

In Table I I present a summary of the main changes of the audit reform that took place internationally, in the US and in the UK.

TABLE I. MAIN CHANGES OF THE AUDIT REFORM

Change	IAASB	PCAOB	FRC	EU
New section for KAM/CAM	X ^a	X ^b	X ^c	X ^c
Disclosure of the name of the engagement partner	X	X	X	X

Prominent placement of opinion section and basis for opinion section	X		
Disclosure separately going concern issues	X		X
Statement about the auditor's independence and fulfilment of relevant ethical responsibilities	X	X	X
Enhance description of auditor's responsibilities	X		
Statement regarding the auditor's consideration of other information in the annual report	X	X	X
Disclosure of auditor tenure		X	X
Auditor's opinion on internal control		X	
Information on the extent to which the audit was capable of detecting irregularities, including fraud			X

Source: adapted from Prasad & Chand (2017).

^a KAM; ^b CAM; ^c description of risks of material misstatement.

III. RESEARCH ON THE EFFECT OF KAM ON USERS

The revised audit report should provide additional information to users reducing the information gap (difference between what users expect on an audit and what an audit really is). It is expected an influence of KAM disclosure on investor and market reaction. Since the introduction of KAM disclosure is recent some studies are based on experimental designs instead (Bookaly & Quick, 2016; Christensen, Glover & Wolfe, 2014; Sirois, Bédard & Bera, 2018) on archival data (Gutierrez, Minuta-Meza, Tatum & Vulcheva, 2018).

A. Experimental design

The first published paper analysing the impact of KAM disclosure on investor decision and market reaction, and using an experimental was the Christensen, Glover and Wolfe (2014) paper, as it is shown in Table II. Studying the influence of the KAM on business school graduates (acting as non professional investor) decision they find that a KAM paragraph, about uncertainty of fair value estimates in audit report, influences more investors than that information solely disclosure in financial statements notes, since the investors are more likely to stop investing on the company than investors receiving a traditional audit report (without a KAM).

Bookaly and Quick (2016) conducted an experiment on German bank directors (another type of users) to analyse the effect of expanded audit report on their perception of audit quality and reporting, as well on their credit granting decisions. Their findings are that there is no influence of disclosure KAM on audit report on perceived accounting, auditing and audit reporting quality and credit approval decisions. This opposite conclusion to Christensen et al. (2014) paper, could be explained by the different German setting, since the auditor liability is limited and public oversight of auditors is weak, as well the type of user is not the same, in this case it was analysed the creditors' behaviour.

Sirois, Bédard and Bera (2014) in a curious laboratory experiment, conducted on postgraduate accounting students (as junior financial analysts), using eye-tracking technology to assess the attention-directing role of KAM on whether KAM influences users' decisions. The objective of the experiment was to assess whether users' information acquisition behaviour differs between the previous auditor report and the new one

with KAMs, the number of KAM in the audit report, and the format of KAM. The results show that, KAM influences positively the attention devoted by participants on KAM related disclosures as well they search them more rapidly. However, they find that, the participants pay less attention to both KAM and non KAM related disclosure when three matters are communicated on the audit report, than when only one matter is communicated in the audit report.

TABLE II. REVIEWED PAPERS: EXPERIMENTAL DESIGN

Date	Authors	Sample	Main results
2016	Bookaly and Quick	German, 105 bank directors	No significant influence of KAM is found on perceived accounting, auditing and audit reporting quality.
2017 (wp)	Carver and Trinkle	US, 150 private investors	CAM have a negative impact on readability as well decrease perceived management's credibility.
2014	Christensen et al.	US, 141 private investors (alumni)	The investment decision is changed with a CAM disclosure.
2016 (wp)	Dennis et al.	US, 102 private investors (MBA students)	The auditor estimate disclosures are value-relevant for users' investment decisions.
2016 (wp)	Köhler et al.	Mainly Germany, 89 professional investors and 69 nonprofessional investors	Professional investors value positively the KAM information, which it is not the case for nonprofessional investors meaning that the KAM information has no communicative value.
2018	Sirois et al.	Canada, 98 students acting as a junior loan officer.	Users pay more attention to KAM related disclosures and disclosures of several KAM reduces attention towards other parts of the financial statements..

B. Archival data

There is only one published archival paper on the influence of disclosure KAM on investor or market reaction that I know (Table III). Gutierrez et al. (2016) studied nonfinancial companies in UK listed in London Stock Exchange (LSE) premium category and traded on the main market, and the influence of the KAM disclosure on investor reaction, audit quality and audit fees. They used a difference-in-difference research design, comparing two groups of companies, one that has to mandatory disclosure KAM and the other one do not have. Using absolute abnormal returns and abnormal trading volume as proxies for investors' reaction to KAM disclosure, they do not find any evidence of an incremental short market reaction. These conclusions may be due to the auditor disclosures may be anticipated by other information, the market believes the auditor deals adequately with the KAM disclosure or the market does not understand the implication of KAM disclosure.

TABLE III. REVIEWED PAPERS: ARCHIVAL DATA

Date	Authors	Sample	Main results
2018 (wp)	Almulla and Bradbury	New Zealand, 2015 to 2017	Recurring KAM disclosure are not value relevant.
2018 (wp)	Bédard et al.	France, 2002 to 2011	

IV. CONCLUSION

The previous audit report was viewed as a pass/fail report, too standardized and communicating insufficient audit information. Hence, the audit standard setters and regulatory bodies have initiated an audit reform, changing the structure and content of the audit report and among other things, they add to the audit report a new section for disclosure KAM, being these the auditor's judgment most significant matters. The disclosure of KAM is mandatory for the period 2016 by IAASB and EU and 2019 or 2020 in US depending on the type of audited company. The IAASB through the introduction of KAM expects a positive effect on audit quality or users' perception of it, therefore audit report is the only form the auditor has to communicate information about the audit.

Being one of the most important audit changes the main objective of the paper is to overview and synthesis of the emerging paper on the influence of the KAM section on users and market reaction. Being a very recent issue the published paper are very scarce, mainly the ones based on archival data, however is very important to overview those papers and suggest new possibilities to study.

I divide the papers based on the type of research design, thus experimental ones and archival data. On experimental design papers conducted in US and Canada it is found that KAM influence users' perception of audit quality when users are non professional investors or junior financial analysts, however, on an experiment that took place in German on bank directors it is not found any influence of KAM disclosure on audit quality's perception and credit approval decisions. On the only published archival data paper it is not found that the KAM disclosure significantly affects investors reaction in UK.

Focusing only in users and market reaction, and due to two factors, the scarcity of published papers and mixed results, one can say that there is insufficient research. Until now, the paper have studied just one country, type of users and used one specific methodology. Moreover, even apparently the disclosure KAM seems detached from improving audit quality, does not means that disclosure KAM is not relevant for users. Furthermore, the process of producing KAM could be analysed to understand the motivation attached.

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