# A Comprehensive Study of the New Audit Report with Key Audit Matters:

## What have We Learnt from our First Implementation?

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Funded by the Higher Education Commission and the Thailand Research Fund

# Motivations

**The Audit report has been criticized** as not providing stakeholders with much information beyond the qualified vs. unqualified opinion

Standardized language and form is perceived to make the audit report *less communicative and informative*.

Expectation Gap

# Motivations

## The new enhanced auditor reporting standards

requirement for auditors of listed companies to disclose

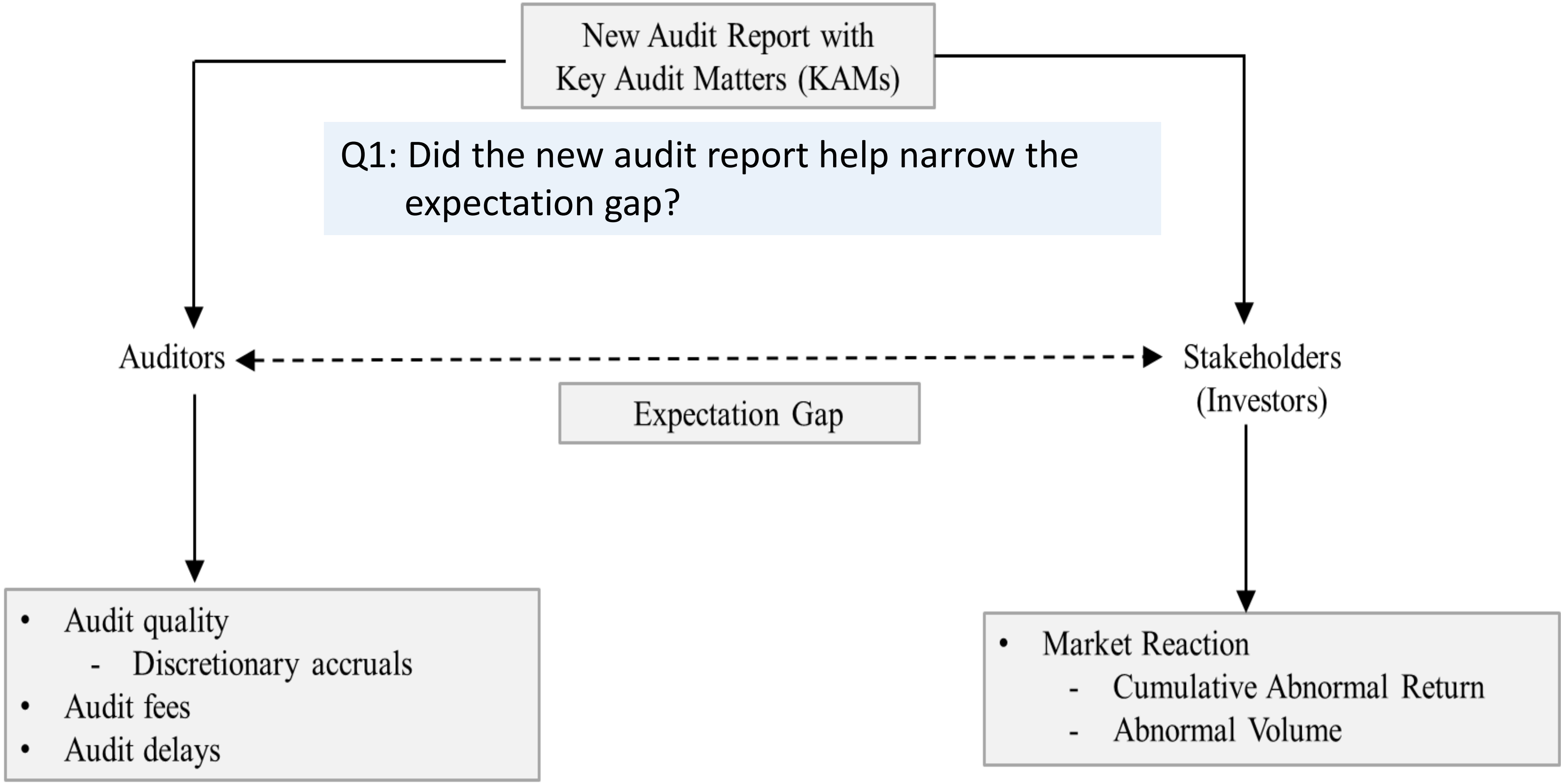
### "Key Audit Matters (KAMs)"

Matters that the auditor considered to be of most significance
in the audit of financial statements

Provide greater transparency

Improve communications between auditor and investors/audit committees and board of directors

# Research Questions and Framework



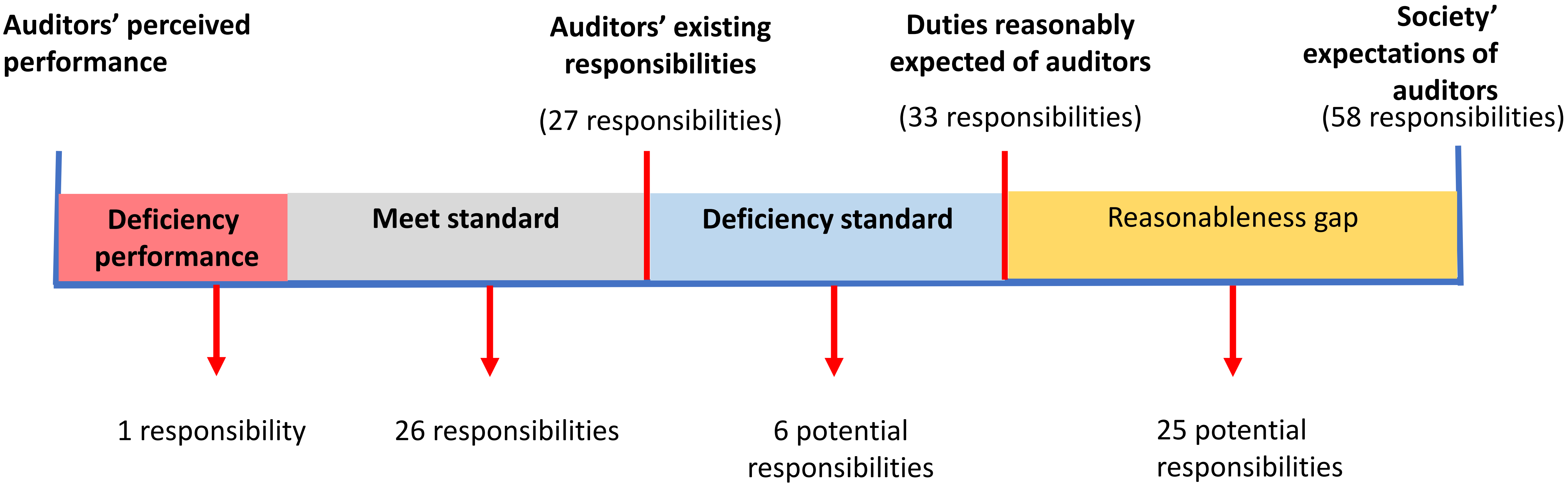

Q2: Did the new audit report impact auditors?

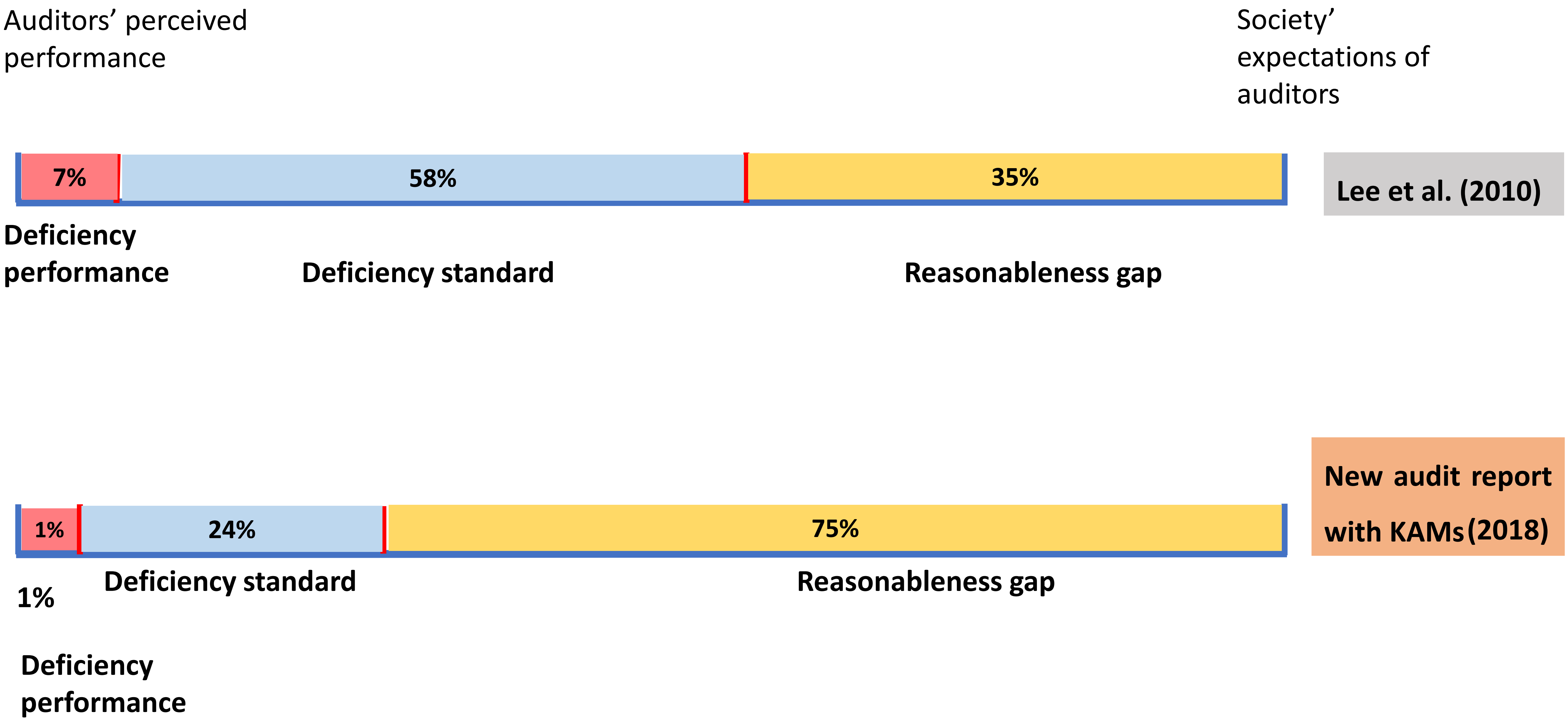
Q3: Did the new audit report impact market reaction?

# Q1: Did the new audit report help narrow the expectation gap?

- The survey questionnaire was developed based on those of Porter et al. (2012a) and Lee et al. (2010).
- Questions related to 64 actual and potential responsibilities of auditors.
- Respondents were asked to give their opinions on each suggested responsibility listed in the questionnaire in respect of three questions:
  1) whether the suggested responsibility is an existing responsibility of auditors,
  2) if so, how well the auditors performed the responsibility, and
  3) whether the suggested responsibility should be the auditors' responsibility.

| Survey groups | Number of distributed questionnaires | Number of usable responses | Percentage of usable responses (%) |
|---|---|---|---|
| **Auditees:** | | | |
| Independent committee | 400 | 13 | 3% |
| Board of directors | 400 | 45 | 11% |
| Audit committee | 400 | 27 | 7% |
| CFO/Accounting manager | 400 | 19 | 5% |
| Internal auditors | 400 | 8 | 2% |
| **Total** | 2,000 | 112 | 6% |
| **Audit beneficiaries: Financial Community:** | | | |
| Stockbrokers | 30 | 21 | 70% |
| Financial analysts | 30 | 3 | 10% |
| Bankers-corporate lenders | 30 | 14 | 47% |
| Institutional investors | 30 | 0 | 0% |
| Auditing/accounting regulator | 10 | 0 | 0% |
| Auditing academics | 30 | 5 | 17% |
| **Total** | 160 | 43 | 27% |
| **Audit beneficiaries: Non-financial community** | | | |
| Solicitors | 20 | 1 | 5% |
| Financial journalists | 20 | 1 | 5% |
| General public | 30 | 21 | 70% |
| **Total** | 70 | 23 | 33% |
| **Combined totals** | 2,230 | 178 | 8% |


Auditors' perceived performance
Auditors' existing responsibilities
(27 responsibilities)
Duties reasonably expected of auditors
(33 responsibilities)
Society' expectations of auditors
(58 responsibilities)
Deficiency performance
Meet standard
Deficiency standard
Reasonableness gap
1 responsibility
26 responsibilities
6 potential responsibilities
25 potential responsibilities


Auditors’ perceived performance
Society’ expectations of auditors
7%
58%
35%
Lee et al. (2010)
Deficiency performance
Deficiency standard
Reasonableness gap
1%
24%
75%
New audit report with KAMs(2018)
Deficiency standard
Reasonableness gap
1%
Deficiency performance

# Q2: Did the new audit report impact auditors?

- Archival study
- Hypotheses were developed from previous study and tested by using regression analysis
- Data covered two years before and after the implementation of the new audit report.

# H1: KAMs and Audit Quality


$$ABDAC = \alpha + \beta_1 \boldsymbol{KAMsDisclose} + \beta_2 LOGASSETS + \beta_3 LEVERAGE + \beta_4 ROA + \beta_5 LOSS + \beta_6 SALEGROWTH + \beta_7 MB + \beta_8 CFO + YFIXEFF + INDFIXEff + \varepsilon \qquad (1)$$

| | |
|---|---|
| $ABDAC$ | = absolute value of discretionary accruals computed by the modified Jones model, including ROA; |
| $\boldsymbol{KAMsDisclose}$ | = 1 for the audit of financial statements for the year-ending on or after 15 December 2106 when disclosing KAMs is required, 0 otherwise; |
| $LOGASSETS$ | = natural logarithm of total assets; |
| $LEVERAGE$ | = total debts divided by total assets; |
| $ROA$ | = net income divided by total assets; |
| $LOSS$ | = 1 if the company reported loss, 0 otherwise; |
| $SALEGROWTH$ | = sale volatility, which is changed to sales divided by total assets; |
| $MB$ | = ratio of market to book value of equity; |
| $CFO$ | = cash flow from operations; |
| $YFIXEFF$ | = dummy variables of year's fixed effects; and |
| $INDFIXEFF$ | = dummy variables of industry's fixed effects. |

# H2: KAMs and Audit Fees


$$\textcolor{red}{LAFEE} = \alpha + \boldsymbol{\beta_1 KAMsDisclose} + \beta_2 LOGASSETS + \beta_3 LEVERAGE + \beta_4 ROA + \beta_5 LOSS + \beta_6 SALEGROWTH + \beta_7 CURR + \beta_8 AR + \beta_9 INV + \beta_{10} BIG4 + YFIXEFF + INDFIXEFF + \varepsilon \quad (2)$$

$\textcolor{red}{LAFEE}$ = the natural logarithm of audit fee;
$CURR$ = current assets divided by current liabilities;
$AR$ = accounts receivable divided by total assets;
$INV$ = inventories divided by total assets;
BIG4 = 1 for the Big 4, 0 otherwise.

# H3: KAMs and Audit Delays


$$LADELAY = \alpha + \boldsymbol{\beta_1 KAMsDisclose} + \beta_2 LOGASSETS + \beta_3 LEVERAGE + \beta_4 ROA + \beta_5 LOSS + \beta_6 SALEGROWTH + \beta_7 MB + \beta_8 CFO + \beta_9 BUSY + \beta_{10} BIG4 + \beta_{11} LAFEE + YFIXEFF + INDFIXEFF + \varepsilon \quad (3)$$

$LADELAY$ = the natural logarithm of audit delay counting from the date of year-ending for accounting period to the date of auditor report;

$BUSY$ = 1 if the date of year-ending for accounting period is 31 December, 0 otherwise;

# Q3: Did the new audit report impact market reactions?

- Prior studies show that the financial market reacts when explanatory language is added in the audit report (Czerney, Schmidt, & Thompson, 2014; Menon & Williams, 2010).
- This disclosure of KAMs may affect stock prices or trading volume, which are generally used to gauge the usefulness for market decisions because they provide new information to investors.
- Unless they are difficult to understand, KAMs may affect the market reaction in terms of investment decisions and attention to information provided (Bédard et al., 2019).

# H3: KAMs and Market Reaction

$$CAR = \alpha + \boldsymbol{\beta_1 KAMsDisclose} + \beta_2 LMKC + \beta_3 MB + \beta_4 LEVERAGE + \beta_5 CHNI + \beta_6 CAR3 + \beta_7 BIG4 + YFIXEFF + INDFIXEFF + \varepsilon \quad (4)$$

$CAR$ = cumulative abnormal return which expect return was computed by using five-factor pricing model of Fama and French (2015);
$LMKC$ = natural logarithm of market capitalization;
$CHNI$ = current year's net income less previous year's net income divided by total assets;
$CAR3$ = the absolute value of the sum of the three-day absolute $CAR$ during the period surrounding the financial statement submitting date;

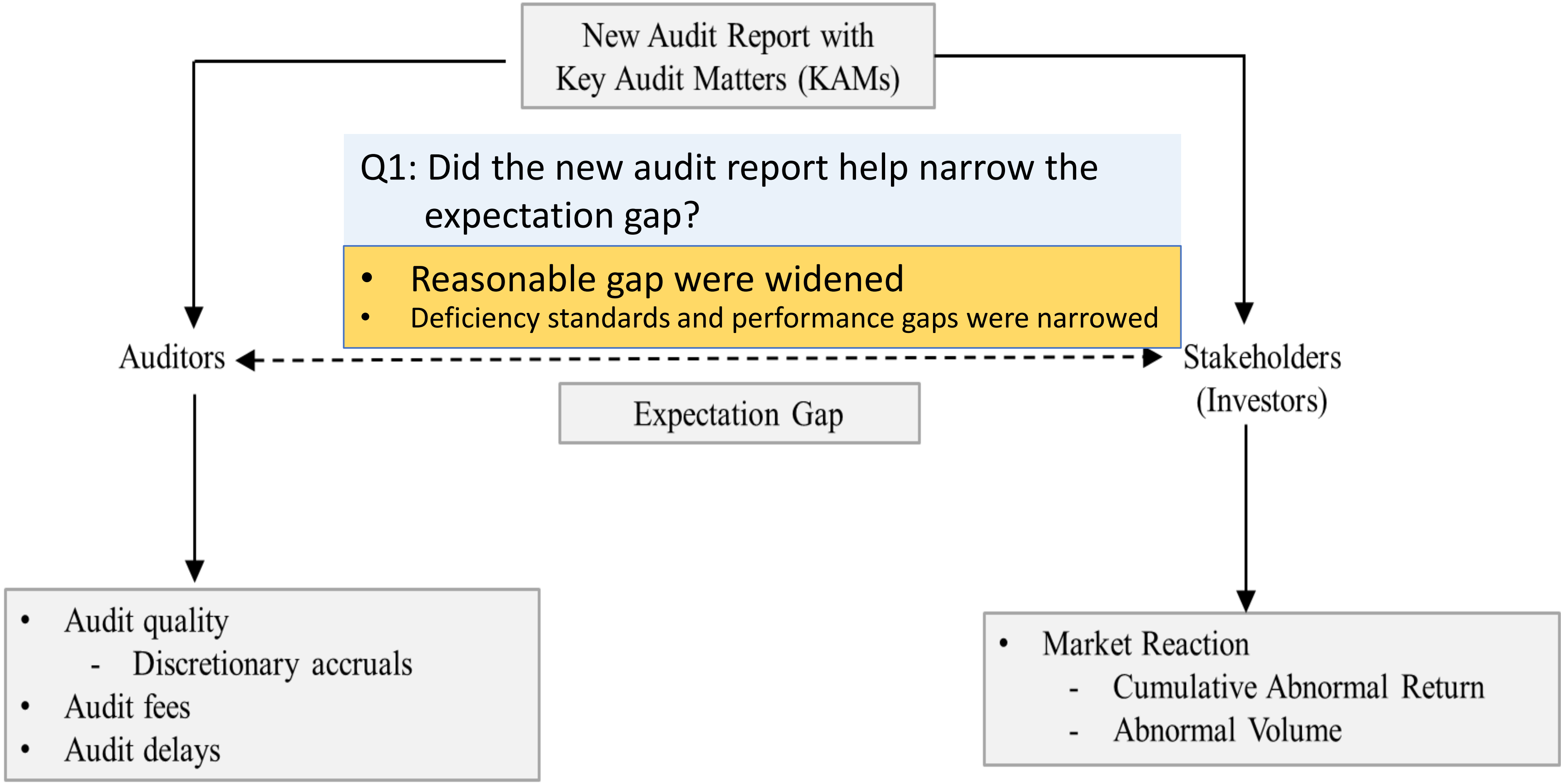
$$ABTV = \alpha + \boldsymbol{\beta_1 KAMsDisclose} + \beta_2 LMKC + \beta_3 ROA + \beta_4 LOSS + \beta_4 CAR3 + YFIXEFF + INDFIXEFF + \varepsilon \quad (5)$$

$ABTV$ = Pevzner et al.'s (2015) cumulative abnormal trading volume;

# Results

| | Coef. | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | ABDAC | | LAFEE | | LADELAY | | CAR | | ABTV | |
| KAMsDisclose | -0.055 | * | 0.135 | ** | 0.031 | * | 0.002 | | 0.417 | |
| LOGASSETS | -0.006 | *** | 0.336 | *** | -0.013 | *** | | | | |
| LEVERAGE | 0.002 | | 0.106 | *** | 0.016 | *** | -0.009 | | | |
| ROA | -0.164 | *** | -0.803 | *** | -0.126 | | -0.009 | | 2.716 | |
| LOSS | 0.020 | ** | 0.042 | | -0.011 | | | | -0.292 | |
| SALEGROWTH | -0.059 | *** | -0.016 | | 0.037 | ** | | | | |
| MB | -0.002 | | | | -0.002 | | 0.000 | | | |
| CFO | 0.221 | *** | | | -0.138 | *** | -0.046 | *** | | |
| CURR | | | -0.006 | | | | | | | |
| AR | | | 0.051 | | | | | | | |
| INV | | | -0.119 | | | | | | | |
| BUSY | | | | | -0.012 | | | | | |
| LAFEE | | | | | 0.023 | *** | | | | |
| BIG4 | | | 0.216 | *** | -0.049 | *** | 0.005 | ** | | |
| LMKC | | | | | | | 0.002 | * | 0.003 | * |
| CHNI | | | | | | | 0.110 | *** | | |
| CAR3 | | | | | | | -0.084 | | 26.166 | *** |
| Intercept | 0.256 | *** | 6.880 | *** | 4.013 | *** | -0.046 | *** | 0.865 | *** |
| YFIXEFF | Yes | | Yes | | Yes | | Yes | | Yes | |
| INDFIXEFF | Yes | | Yes | | Yes | | Yes | | Yes | |
| Robust variance estimates | Yes | | Yes | | Yes | | Yes | | Yes | |
| N. Obs. | 1,414 | | 1,375 | | 1,355 | | 1,270 | | 1,270 | |
| Adjusted R2 | 0.13 | | 0.49 | | 0.12 | | 0.05 | | 0.13 | |

# Conclusion




Q1: Did the new audit report help narrow the expectation gap?

- Reasonable gap were widened
- Deficiency standards and performance gaps were narrowed

Q2: Did the new audit report impact auditors?

- KAMs improves audit quality
- KAMs increase audit fees
- KAMs increase audit delays

Q3: Did the new audit report impact market reaction?

- Disclosing KAMs <u>does not</u> impact market reaction

# Discussion and Implications

1. The reasonableness gaps were widened from 35% in 2010 to 75% in 2018.

  - dynamic changes in the business world have led to more complex business transactions
  - greater expectations of auditing functions than those in the past and thus have magnified the reasonable gap.

- To narrow the reasonable gap: the reforms of the audit report should be done in parallel with proactive approaches to educating users about audit functions.
  - Standard setters and regulators in Thailand should seek efficient ways to help users understand and recognise the importance of audit functions.
  - Promoting on-going and proactive education on auditing through mass media, seminars and the website of the Thailand Federation of Accounting Professions (www.tfac.or.th) as well as encouraging public debates and discussions on auditing issues.

# Discussion and Implications

2. This study is the first to provide evidence that the deficiency standards gaps were narrowed from 58% in 2010 to 23% in 2018.

- The large reforms of the auditor report and related auditing standards in 2016, especially the requirement for auditors to disclose KAMs.

- However, the remaining gap is associated with *society's reasonable expectations of auditors to:*
  - *examine and to report in the audit report the effectiveness of the client's internal financial controls,*
  - *the reliability of information provided on the Internet by the client in its audited financial statements as well as information in the client's entire annual report.*

  Performing these responsibilities would make audits more valuable and would increase benefits to society.

# Discussion and Implications

3. The deficiency performance gaps were narrower after the implementation of the new audit report from 7% in 2010 to 1% in 2018.

- The auditors' existing responsibilities to ***detect deliberate distortion of the client's financial statements and to disclose it in the audit report***, which contributed to the deficiency performance gap in 2010, disappeared in 2018.
  - This may be due to close monitoring (e.g. audit firm inspection) of auditors' performance by the Security Exchange and Commission and the tremendous effort of the Thailand Federation of Accountants to promote audit quality.
- However, a new deficiency performance gap was found in 2018. The gap is the auditors' responsibility to ***disclose in the audit report illegal acts by the client's directors/senior management that directly impact the client's financial statements***.
  - This may have resulted from the series of illegal acts by the listed companies' directors/senior management reported by mass media in the past few years. Society has therefore perceived that auditors' performance is unsatisfactory.
  - To close this gap, the standard setters should raise auditors' awareness of detecting and reporting illegal acts committed by companies' management and should also closely monitor the auditors' performance.

# Discussion and Implications

4. The archival data analyses provided weak evidence that the new audit report with KAMs improves audit quality by reducing discretionary accruals. It is possible that disclosing KAMs leads auditors to feel more responsible (Bédard et al., 2019; Li et al., 2019) and accountable (Li et al., 2019), thereby seeking more and better audit evidence and having more professional scepticism in their audits (Bédard et al., 2019).

# Discussion and Implications

5. The analyses also provided weak evidence that disclosing KAMs has economic consequences by increasing audit fees and audit delays. After the implementation of the new audit report in Thailand, audit fees and audit delays increased by approximately 14.4% and 3.2%, respectively.

- Audit firms must spend resources and time preparing and training their staff, especially in the first year of the implementation of KAMs (Li et al., 2019; Reid et al., 2018). Costs associated with preparing and training staff may be added to their audit fees and absorbed by their clients.
- Increases in audit fees may compensate for increases in audit risk and audit effort. Auditors may face a higher litigation risk when misstatements are found (Wei et al., 2017) after disclosing KAMs.
- Disclosing KAMs increases audit effort (Almulla & Bradbury, 2018; Bédard et al., 2019) . It increases senior members' working hours on the disclosure of KAMs (Bédard et al., 2019). KAMs may also lead to disagreements between auditors and management, and thus auditors may spend more time discussing these matters with audited companies' managers and audit committees (Reid et al., 2018).

# Discussion and Implications

6. The archival data analyses support that KAMs have little informative value to users and provide redundant information. Cumulative abnormal returns and abnormal trading volumes around the dates that audited companies filed their audited financial statements on the SEC's website were observed, and it was found that disclosing KAMs does not impact the market reaction.

- As pointed out by Almulla and Bradbury (2018), in New Zealand, investors had already known matters disclosed as KAMs in the year before the implementation of the requirement for disclosing KAMs.
- Wei et al. (2017) found that in Australia, one-third of matters disclosed as KAMs had already been reported in audited clients' previous year's annual report before the implementation of the requirement for disclosing KAMs.
- This finding is similar to those of Bédard et al. (2019) and Gutierrez et al. (2018). Bédard et al. (2019) found that disclosing JOAs does not impact abnormal returns or abnormal trading volume in France. Gutierrez et al. (2018) found that disclosing RMMs does not impact absolute abnormal returns or abnormal trading volume in the UK.

# Discussion and Implications

To alleviate users' confusion regarding KAMs and to reduce their belief that KAMs have little informative value and provide redundant information, standard setters and regulators in Thailand should seek efficient ways to proactively educate users regarding KAMs by promoting users' understanding of audit functions and encouraging a greater recognition of the importance of audit functions.

# Thank you