

EMPIRICAL RESEARCH ON EUROPEAN COMPANIES AND FACTORS INFLUENCING KEY AUDIT MATTERS DISCLOSURE

Teodora-Cezara PORUMBACEAN

Babes Bolyai University, Cluj-Napoca, Romania

Abstract. *The paper aims to determine factors influencing the disclosure of the Key Audit Matters in the Audit Report at large European companies. The paper proposes an analysis over a period of 4 years from 2017-2020 of 1,681 European companies available on the Audit Analytics database by assessing eight hypotheses that contain factors that might influence KAMs disclosures, namely: the industry and country of the audited company, audit fee, gender of the audit partner, type of auditor (Big4/ non-BIG4), type of audit opinion and going concern risks and financial performance indicators (ROA, ROE, ROI). These hypotheses will be tested by using a regression model. Based on the analysed papers addressing the proposed topic, it is expected that the study results would show positive correlations between the above-listed factors and the number of KAMs disclosed. At the time of this writing and to the author's best knowledge, no significant amount of such studies targeting the factors influencing the key audit matters disclosure has been conducted, and the research gap in the audit literature regarding the factors influencing KAMs still exists. Moreover, the research intends to contribute to the general public's understanding of the main auditing issues in European companies that are relevant to the auditors, providing evidence on factors associated with KAMs disclosure. This paper is helpful for auditing standards setters and the users of the financial statements. Nevertheless, it facilitates the decrease of the expectation gap between the auditors and the audit report users.*

Keywords: Key Audit Matters, Audit Report, ISA701

Introduction

The purpose of the audit reports is to facilitate the communication of the auditors' concerns and opinions, regarding the accuracy and completeness of the financial statements, to various categories of stakeholders, such as investors, debtholders, shareholders, standard setters, regulators and other external users (Pratoomsuwan & Yolrabil, 2018).

Prior research raise several concerns regarding the quality of the audit report and the expectation gap between the stakeholders and the auditors (Church, et al., 2008), also highlighting situations in which the auditors fail to identify financial statements that do not present a true and fair image of the audited company's actual financial information. (Guiral-Contreras, et al., 2007) All these aspects generate an overall distrust of the auditor's work and lead to continuous debates on the matter. (Vanstraelen, et al., 2012)

The International Auditing and Assurance Standards Board (IAASB) adopted International Standard on Auditing (ISA) 701 in response to concerns that stakeholders raise and in an attempt to reduce the information gap and the information asymmetry between the users of the financial statements and the auditors, as well as to improve transparency, increase audit quality and make the audit reports more relevant for their users.

Consequently, the audit report suffered some modifications and the auditor has an additional objective, namely, to determine key audit matters (KAMs) and communicate those that in the auditor's professional judgement were of most significance in auditing the financial statements of the current period, by describing them in the auditor's report.

Before the implementation of ISA 701, 'the auditor's report structure had been much simpler than it is today, with reports usually comprising of brief paragraphs' (Tiron-Tudor, et al., 2018).

However, a gap between auditors and users also existed, particularly due to the users' comprehension of a report that had become even more complex and quite difficult to follow.

After the introduction of the KAMs paragraph to the audit report, the fieldwork included performing more audit procedures on the audited financial accounts. (Marques, et al. (2019) Moroney, et al. (2020) demonstrate that the inclusion of the KAMs paragraph in the audit report improves its perceived value and offers greater credibility only when a Non-Big Four audit company issues it. On a more positive note, Sirois, et al. (2017) suggest that particularly due to the high level of the KAMs specificity, users can acquire a better understanding of the disclosures: 'KAMs can improve information search and acquisition efficiency by reducing attention to less relevant disclosures' (Sirois, et al., 2018). However, to the authors' best knowledge, the gap in the literature remains; no study performs a rigorous literature review on factors influencing the KAMs disclosure. (Sirois, et al., 2018).

Thus, this paper aims to identify and discuss the key drivers that influence the number of disclosed Key Audit Matters in the audit report based on a structured literature review prior conducted. According to Brouwer, et al. (2016), by measuring the number of KAMs one can have a better understanding of the company's risk level as "the key audit matters reported by the auditor provide new insights to financial statement users with respect to significant estimates and risks reported in the financial statements".

The study intends to contribute to the development of knowledge as follows. First, by testing the factors identified in the literature through a regression model, where the number of disclosed KAMs is the dependent variable. Second, this study intends to facilitate better understanding of the KAMs, by explaining how some factors correlate with the matters disclosed, to enable more informed decision-making based on the information the audit report provides.

2. Knowledge in the field – Literature review

Nowadays, users' expectations of the financial statements and audit reports have increased tremendously, and so has the implicit pressure on authors to provide as much assurance as possible regarding the financial statements. In an attempt to decrease this expectation gap, to increase the quality of the audit and make the audit reports more relevant for users, the International Auditing and Assurance Standards Board (IAASB) adopted International Standard on Auditing (ISA) 701, 'Communicating key audit matters in the independent auditor's report', which became effective for audits of financial statements for periods ending on or after December 15, 2016.

In order to provide a structured overview of the key factors influencing KAM disclosure identified in the literature, a summary is presented below in Table 1, followed by detailed explanation.

Table 1. KAM Disclosure factors

FACTOR	REFERENCE
1. GENDER OF THE AUDITOR/AUDIT PARTNER	(Abdelfattah, et al., 2020)
2. CULTURAL/ OTHER EXTERNAL FACTORS	(Velte, 2018)
3. INDUSTRY OF THE AUDITED COMPANY	(Abdullatif & Al-Rahahleh, 2020) (Pinto & Morais, 2019) (Sierra-Garcia, et al., 2019) (Velte, 2020) (Wuttichindanon & Issarawornrawanich, 2020)

4. PRESENCE OF SIGNIFICANT ACCOUNTING ESTIMATES AND UNCERTAINTY DIRECTLY RELATED	(Asbahr & Ruhnke, 2019) (Lau, 2020)
5. COUNTRY OF THE AUDITED COMPANY	(Ciger, et al., 2019) (Lau, 2020) (Wuttichindanon & Issarawornrawanich, 2020)
6. EXISTENCE AUDIT COMMITTEE	(Abu & Jaffar, 2020) (Vasconcelos, et al., 2020) (Wuttichindanon & Issarawornrawanich, 2020)
7. TYPE OF AUDIT COMPANY (BIG FOUR/NON-BIG FOUR)	(Abdullatif & Al-Rahahleh, 2020) (Filipovic, et al., 2019) (Kend & Nguyen, 2020) (Moroney, et al., 2020); (Sierra-Garcia, et al., 2019)
8. AUDIT MARKET STRUCTURE	(Gambetta, et al., 2019)
9. ACCOUNTING STANDARDS APPLIED ON PARTICULAR ACCOUNTING ITEM/FINANCIAL STATEMENT LINE ITEM	(Cortes de Vasconcellos, et al., 2019) (Kend & Nguyen, 2020) (Pereira, et al., 2020) (Pinto & Morais, 2019) (Warzocha, 2018)
10. AUDIT FEE	(Mamcarczyk, et al., 2020); (Pinto & Morais, 2019); (Sierra-Garcia, et al., 2019)
11. NUMBER OF BUSINESS SEGMENTS (COMPLEXITY OF THE COMPANY'S BUSINESS)	(Pinto & Morais, 2019); (Sierra-Garcia, et al., 2019)
12. LEVEL OF REGULATION OF THE MARKET	(Pinto & Morais, 2019); (Sierra-Garcia, et al., 2019)
13. CLIENT RISK LEVEL	(Pinto & Morais, 2019);
14. EXISTENCE OF DIRECTORS AND OFFICERS (D&O) LIABILITY INSURANCE AT THE COMPANY	(Lin, et al., 2020)

Source: Authors' projection

For the purpose of this study, the literature review focuses only on the factors correlated to the research model proposed in the upcoming sections. The type of audit company plays a significant role, due to the subjectivity and scepticism level of each auditor and each company's methodology. Thus, it comes as no surprise that variations in judgement and different interpretation methods surrounding ISA 701 arise from one company to another, 'differences between large and small audit practitioners related to the average number of KAMs disclosed and the average number of audit procedures undertaken per KAM' (Kend and Nguyen, 2020).

In addition, the studies also reveal that the industry of the audited company influences the disclosed KAMs. From one angle, Abdullatif and Al-Rahahleh (2020) observed 'a tendency to avoid entity-specific matters and a preference to concentrate on industry-specific matters'. The complexity involved in the accounting treatment is also likened to the regulations applicable in specific industries. Wuttichindanon and Issarawornrawanich (2020) demonstrate that 'firms with many subsidiaries and firms in the technology, property and construction and finance have higher numbers of KAMs', a

conclusion that is quite in opposition to Pinto and Morais's (2019) findings, which show that 'auditors disclose less KAMs for financial institutions; although auditors may disclose more KAMs in banks due to the complexity and opacity of this industry, the fact that the industry is very well regulated and supervised may lead them to find less areas of risk'. This could be due to regulated industries already having a good level of monitorisation and supervision, leaving less space for possible errors and implicitly needing to disclose KAMs.

Another crucial factor directly linked with those above is the audit fee that also varies with the size of the company and the risk associated with that business. Thus, 'a positive association exists between the audit fee and the number of KAMs disclosed' (Pinto and Morais, 2019) Also, 'the higher number of reported KAM was connected with the amount of an audit fee' (Mamcarczyk et al., 2020). The correlation itself is quite controversial; 'as audit fees are the main source of income for auditors, the level of relevance of a client can determine the incentive that auditors have to compromise their independence' (Pinto and Morais, 2019).

From a geographic perspective, the country of the audited company (A5) could also correlate with the KAMs disclosure. Ciger et al. (2019) identify some countries from CEE, namely Poland, Romania, and Turkey, that see up to six KAM subheadings reported. However, on the opposite side, the Czech Republic is 'the only country in which all auditor reports include a KAMs section', whereas 'Romania has the highest percentage of audit reports that do not include a KAMs section'. The results are purely statistical; no hypothesis was tested respecting this factor, but further research might benefit from investigating possible differences between the regions of Europe.

3. Motivation and Research Objectives

The Key Audit Matters initial purpose was to increase the quality of the audit report and increase confidence level of the users in the work performed by the auditors, as the assurance services have a major contribution in the accounting stability, by better understanding what factors stand behind this disclosures, the users of the audit report can gain more trust in the work performed by the auditors (Jermakovicz, et al., 2018) .

The aim is to study possible correlation between factors that are considered to influence the number of disclosed KAMs, by testing the proposed 5 hypotheses through a panel data regression model. The rationale for studying the number of disclosed KAMs is that this aspects can give one a better overview of the company's risk level.

The study intends to contribute to the development of knowledge as follows. First, by testing the factors identified in the literature through a panel data regression model, where the number of disclosed KAMs is the independent variable.

Second, by its results, this study also intends to facilitate to the audit report stakeholders a better understanding about the KAM by providing explanations concerning how the selected factors are correlated with the matters disclosed, in order to be able to make more informed decisions based on the information provided by the audit report.

Additionally, ISA 701 is effective for audits of financial statements for periods ending on or after December 15, 2016, which for the researchers is still considered a short time-span between implementation and current period, therefore, not much has yet been written regarding the factors influencing KAMs.

4. Research Methodology

The following section describes the methodological procedures that will be used in order to answer to the following research question:

Q1. Which factors influence the number of KAMs at large European companies?

The paper proposes an analysis over a period of 4 years from 2017-2020 of 1,681 European companies available on the Audit Analytics database by assessing eight hypotheses that contain factors identified in the literature that might influence KAMs disclosures, namely: the industry and country of the audited company, audit fee, type of auditor (Big4/ non-BIG4) and type of audit opinion.

The dependent variable used is the number of disclosed KAMs tested in correlation with the independent variables which are represented by the six factors listed above. Hence, considering that paper studies multiple objects over a period higher than one year, a panel regression model is proposed in this sense, in order to respond to the following listed investigation hypothesis.

H1: There is a positive relationship between the number of KAMs and the industry of the audited company.

Some sectors are more regulated than others (Pinto & Morais, 2018), and therefore, some industries could raise more difficulties for auditors than others (Hay, Knechel, & Wong, 2006; Simunic, 1980) and implicitly affecting the number of disclosed matters due to the sector's required compliances to applicable laws and regulations (Pinto & Morais, 2018). Similar to the method proposed by Pinto & Morais (2018) the paper starts from the presumption that the financial sector is more regulated than the rest of the sectors and implicitly more riskier, therefore the population will be split between financial and others.

H2: There is an influence of the European region in which the audited company is located on the the number of KAMs.

Ciger et al., 2019; Lau, 2020; Wuttichindanon and Issarawornrawanich, 2020 argue that also the region of the audited company pays a significant role in the number of disclosed KAMs, for this reason, the study aims to identify if both factors correlated influence the disclosure. Based on the reviewed literature, this factor was not yet tested by a hypothesis validation, however it was discussed, fact that highlighted a currently existing literature gap in this sense.

In order to study this correlation, there will be a split of the EU regions in the following categories: Northern Europe (NE), Southern Europe (SE), Western Europe (WE) and Central and Eastern Europe (CEE). Further on, three dummy variables will be used and NE will be the reference point as the KAM disclosure requirement appeared firstly in 2013 in United Kingdom.

H3: There is a positive relationship between the number of KAMs and the audit fee of the audited company.

The audit fee that also varies with the size of the company and the risk associated with that business. Thus, 'a positive relationship exists between the audit fee and the number of KAMs disclosed' (Pinto and Morais, 2019). Also, 'the higher number of reported KAM was connected with the amount of an audit fee' (Mamcarczyk et al., 2020). This factor was studied also in other papers, but on a less extended population, fact that leaves a literature gap that could be filled by this paper.

H4: There is an influence of the company being audited by a Big 4 on the number of KAMs.

Based on preliminary studies, the nature of the audited company, BIG4, non-BIG 4 influences the number of the disclosed KAMs, as detailed in the literature review (Filipovic et al., 2019; Kend and Nguyen, 2020; Moroney et al., 2020; Sierra-Garcia et al., 2019). As far as this factor is concerned, the study will use a dummy variable in order to split the type of audit companies.

H5: There is an influence of the audit opinion type on the number of KAMs.

There is quite a high probability that a qualified or adverse audit opinion can be associated with a higher number of disclosed KAMs. (Ferreira & Morais, 2020). However, previous studies did not conclude on this correlation, as the results were not statistically significant. Considering that no prior study that validates this assumption was identified, nor a study that mentions this factor was found in

the selected literature, the paper intends to test this correlation in order to address another literature gap and to connect these two extremely significant parts of the audit opinion.

5. Preliminary Findings

Based on the literature reviews presented in the second section of this research proposal, multiple challenges for the audit in respect to KAMs disclosure have been identified. The impact of ISA 701 requirement is significant and has a direct influence on the reduction of information asymmetry between investors and auditors, therefore it is the responsibility of the auditor to provide a clear and informative report in order to decrease the information gap in order to diminish the risk of the risk-adverse investors to misinterpret the information from the audit report and reconsider possible investment decisions.

Today's uncertain and complex business environment brings new challenges for auditors regarding corporate reporting and the necessity of meeting user demands. The paper provides some key drivers that influence the disclosure of KAMs in the audit report. Based on the analysed papers addressing the proposed topic, it is expected that the study results would show positive correlations between the above-listed factors and the number of KAMs disclosed.

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