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Original Research Article

Determinants of Key Audit Matters Disclosure

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Abstract

We explore the determinants of Key Audit Matters (KAM) from the inspired confidence theoretical submission. Specifically, a longitudinal research design was utilised with samples covering fifteen (15) banks for the period 2016 and 2017. The hypotheses formulated were tested using the fractional regression method.Following the analysis, the study found a positive and significant relationship between audit fees and the disclosureof key audit matters. While firm size showed a positive non-significant relationship. Given these findings, we conclude that audit fees form a fundamental determinant of the disclosure of key audit matters. The study recommends that; in extending audit reports, organisations should ensure that the objective of credibility and transparency is achieved. This will enhance the quality of audit report.

Keywords: Key Audit Matters, Audit Fees, Firm Size, Inspired Confidence Theory.

JEL classification: *M420*

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INTRODUCTION

A general assumption in the event of accounting failures is that auditors were incompetent and inefficient in carrying out the audit process, notwithstanding that such processes were carried out in line with expected requirements. Following this assertion, it can be deduced that the reliability of an organisation'sfinancial statement and decision-making process of stakeholders is highly dependent on the Auditors' opinion. The Auditor's opinion which is expressed as a report is commonlyperceived as a 'pass' or 'fail' statementalleged as less informative to drive the credibility of an organisation (Mock, Bedard, Coram,& Shawn, 2013).

Spurred by the high spate of distressed firms, the need to question the auditor's role in identifying fraud and errors as well as the credibility of the auditor's report is heightened.Hence, in proffering solutions to the menace of audit report credibility, regulatory bodies developed suggestions for enhancing the audit function. Such development is the compulsory disclosure of Key Audit Matters by the International Standard on Auditing (ISA) 701. The ISA emphasize that the auditor's report has to look beyond the pass or fail statement, therefore, the need for a change and revision in audit reporting (Pran & Reiner, 2016). Also, Cordos and Fulopa (2015) posit that the idea of revision in audit reporting should be directed at achieving audit transparency and audit quality by extending audit report to reduce information asymmetry amidst auditors and stakeholders.Given the ideology that the auditorsand stakeholders are entangled in a circle of trust, extending audit reports will further strengthen the auditors' roles as independent assurance providers to stakeholders, boost organisations' credibility, and expedite stakeholders' decision making (Sirois, Bedard, & Bera, 2018). To provide more relevant information for the users of audit reports, KAM require auditors to highlight the most significant matters for the respective entity. The concept of KAM aims to enhance transparency in the reports by increasing the amount of information relevant to the respective entity.

Notwithstanding the above submissions on the importance of disclosing KAM, from a different perspective, we also assume that reporting key audit matters maybe against the auditor's confidentiality duty regarding their clients (Gold & Heilman, 2019). Thus, we deduce that extensive information disclosures might raise some skirmish with the auditor's professional and ethical disposition when carrying out an audit examination.Also, the introduction of key audit matters could be seen as unnecessary, thus derailing financial statement readers as well as stakeholders (Pran& Reiner,2016; Sirois & Bedard, 2018).Against the above discourse of the benefits and challenges ofa more informative audit report, we consider that KAM may be an important driver of audit quality. But a fundamental question worthy of inquiry is: Do firm possess some certain characteristics that could drive the disclosure of KAM? On this note, the studyhypothesizes that expanding the audit report may be dependent upon certain characteristics such as the firm size and audit fees. Consequently, following the introduction, section two addresses literature review and hypotheses development, section three focuses on the methodology, followed by the research findings, conclusion and recommendation in section five.

2. Literature Review and Hypotheses Development

Key Audit Matters

The International Standard on Auditing, (701:8) defines key audit matters as 'Those matters that in the auditor's professional judgment were of most significance in the audit of the financial statements of the current period'. It also states that key audit matters are selected from matter communicated with those charged with governanceduring the audit.Specifically, the ISA 701 (Par: 5) 'statesthat the auditors should take cognisance of sections of greater evaluated risk of material misstatement; sections in the financial reports that attracts significant auditors judgement, which are also significantly related to management'. This includes accounting estimates that have been evaluated as highly uncertain. Lastly, the ISA 701 also requires that the auditors take into account the impact of significant events that ensued in the course of the reporting year.

The concept of KAM aims to enhance transparency in the audit reports, by increasing the information contentof audit reports to foster audit transparency, reliability, quality, and credibility. According to the Pinto and Morais (2019) the concept of Key Audit Matters (KAM) can be described as an extensive communication which aids in highlighting the challenging sections of an organisation's financial statement. The KAM promotes the communicative value of the auditor's report, by bringing to light relevant overlooked issues, as well as providing guidance on examining the financial reports to enhance better decision-making. In essence, they are regarded as those disclosures that are of utmost importance from the auditor's professional judgment.

In disclosing KAMs, the auditor is required to exude professional judgment, while taking into perspective the nature and magnitude of disclosureswithin the financial statement. This is required to establish the existence of risk in matters examined, whether collecting sufficient and appropriate evidence proved difficult, and the problematic nature of judgment required, and finally to ascertain the limitations of the internal control system, regarding the matter under examination.

Determinants of Key Audit Matters Disclosure

Studies (such as; Gibbins, Richardson, & Waterhouse, 1992; Hossain & Adams, 1995; Mckinnon & Dalimonthe, 1993) on information disclosure have examine determinants from several perspectives, such as; user's perception, environmental incentives, and firm specific characteristics (size, ownership structure, profitability, firm leverage, firm foreign listing). However, the literature on firm size, audit fee and KAM is still emerging. Consequently, this paper examines the possible drivers of KAM from the perspective of the firm size and audit fees.

Firm Size and Key Audit Matters Disclosure

Extending audit disclosure may be dependent on the size of the audit firm as large firms are considered to carry out massive checks. Also, large audit firm hasbetter accounting functions than smaller companies and more resources to carry out comprehensive audit processes than smaller firms. Large audit firms are assumed to perform more powerful tests. As a consequence, larger audit firms are more likely to be associated with more precise information than are smaller audit firms, all things being equal.

Similarly, Moore and Scott (1989) validated methodically that the size of the audit firm has a relationship with its extent of work. Evidence from an earlier study of Krishnan and Schauer (2000) demonstrated that big audit firms with international repute show above average in their audit disclosures, meanwhile, not much is known regarding the smaller firms. The findings from the study of Krishnan and Schauer indicate that large firms tend to comply with IFRS reporting requirements. Similarly, Pinto and Morais (2019) examined firms listed on the FTSE in 2016 fiscal year, they established that firms with large business segments tend to disclose the vast number of KAMs. Although we have limited literature, for this variable, we expect that the accuracy and comprehensiveness of a firm's information may be largely dependent on its size,hence it will not be out of place to hypothesise that audit firm size and disclosing key audit matters are positively related.

Auditor's fees and Key Audit Matters Disclosure

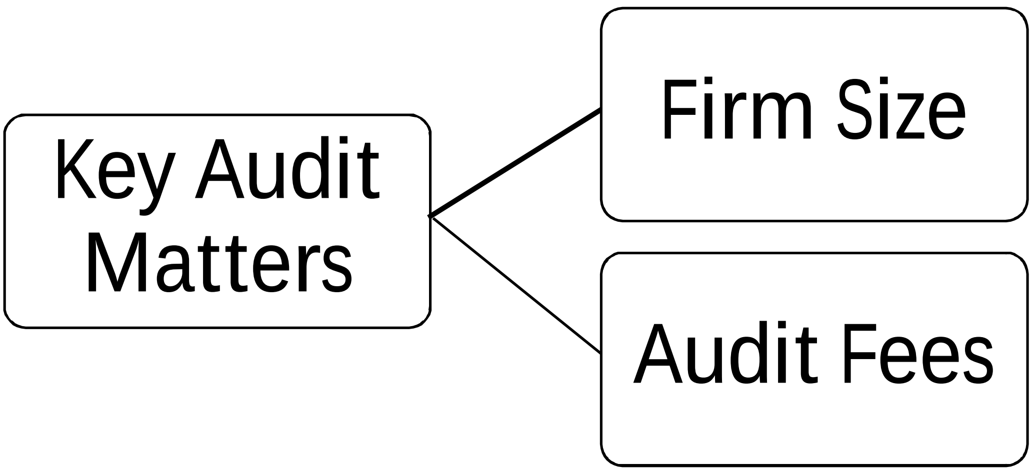
The auditor fee includes the auditor's remunerations for audit and non-audit services rendered. Carcello and Li (2013) documents that disclosing key audit matters makes the organisation more visible to stakeholders, hence, auditors are expected to be accountable. It is based on this assertion that the impact of fees on audit disclosures is reviewed. The disclosure of key audit matters may increase the potential costs borne by auditors if misstatements or accounting fraud are discovered in the future (Brasel, Doxey, Grenier, & Reffett, 2016; Kachelmeier, Schmidt & Valentine, 2015). These audit costs are related to the increase in reputational risk and litigation risk, which are two key drivers of audit effort (DeFond & Zhang 2014). Given these issuesof reputation and litigation, the auditors tend to increase their fees, which in turn could cause organizations to avoid the disclosure of key audit matters. From another perspective, disclosing the key audit matter requires an extension of audit reporting hours, which may ensue in an increase in audit fees. Consequently, firms may drawback in reportage of key audit matters (Rice & Weber 2012). It is reported that companies paying large audit fees to their auditors disclose more extensive reports as seen in Pinto and Morais (2018). Also, evidence from the recent study of Hong, David and David (2019), suggests that as audit report becomes more comprehensive, there was also a significant increase in audit fees.In the light of the above discuss, we hypothesize in null form, that there is no significant relationship between audit fees and KAM disclosure.

Theoretical Framework and Model Specification

The theory of inspired confidence proposed by Limperg1985 emphasizes the need for management to equip users of financial statement with sufficient and relevant information needed to make unbiased decisions. Validating this assertion, Carmicheal (2004) opined that where no public confidence exists, the usefulness of the audit is compromised. According to Limperg (1985), as users need evolves the audit functions are expected to react to the changing needs of users. Following the theory of inspired confidence, we expect that extending audit information disclosures would result in financial reporting quality hence, meeting the teaming needs of users.

Thus, from the theory of inspired confidence we develop the research framework for this study;

Figure 1: Schematic Framework



Source: Researcher’s compilation (2016)

Based on prior studies, this study identifies several variables that could likely affect the disclosure of key audit matters in organisations. First, for firm size, several empirical research such Krishnan and Schauer (2000) and Pinto and Morais (2019) have explored the link between firm size and the key audit matter disclosures and have shown that the size of the firm may be important in its decision to disclose key audit matters. Hence in line with our hypothesis one we predict that *the propensity to disclose key audit matters is significantly related to firm size. The hypothesized functional relationship is presented thus;KAM = f (firm size) --(1)*

Evidence from literature has shown that audit fees influence the disclosure of key audit matters. Studies of Defond and Zhang (2014) andHong, David, and David (2019) supports this assertion. Hence in line with RQ2, we predict that *the propensity to disclose key audit matters is related to the audit fees. The hypothesized functional relationship is presented thus;*

KAM= f (Audit Fees)----------------------(2)

KAM = f(Firm Size, Audit Fee,)----------(3)

3. METHODOLOGY

This study utilized a longitudinal research design. The population comprised all banks quoted on the Nigeria Stock Exchange as at 2017. Consequently, the study sample covers 15 banks for the period 2016 and 2017 and this is because the concept is reflected by the new IAASB audit standard ISA 701 'Communicating Key Audit Matters in the Independent Auditor's Report', which was published in January 2015 and is effective for audits of financial statements ending on or after December 15, 2016. The necessary data were extracted from the annual reports of the banks. The dependent variable; Key Audit Matters (KAM) disclosure is derived using content analysis. According to the requirements of American Institute of Certified Public Accountants (2013) concerning the disclosure of KAM, the following are outlined in determining the disclosure of KAM as adopted in this study (i) Where a description of KAM having its section is given in the independent auditors' report, (ii) disclosure regarding the reason why an issue is a KAM and its effect on the audit (iii) Are there related management statement identifying the issue as a KAM?, (iv) Is standard explanation about the KAM given? (v) and (vi) Does the Auditor(s) state that there is no KAM. With the following criteria, therefore, the disclosure of any item is assigned a score of "1" and then "0" if otherwise which creates the index. Econometric modelling of bounded dependent variables presents limitations for linear estimation methods like the OLS. The fractional response model (FRM) developed by Papke and Wooldridge (1996, 2008) provides a robust approach to deal with the challenges posed by bounded dependent variables. In this study, we employed both techniques.

Against the backdrop of the functional relationships expressed above, the econometric form of the model is given estimated as:

$KAM_{it} = \lambda_0 + \lambda_1 FS + \lambda_2 AUDF + \mu_{it}$ --- (1)

Where:

KAM= Key audit matters disclosure

FS=Firm size

AUF= Audit fee

i =ith firm

t = time period

μ_{it} = Model disturbance term

β_1, β_2, β_S, β_{IN}, β_D, $\varnothing_1$, $\varnothing_2$, $\varnothing_3$ = *slope coefficient*

We presumptively expect that an increase in the size of the firm and audit fees will ensue in KAM disclosure.

Therefore, $\beta 1, \beta 2 > 0$

4. ESTIMATION RESULTS AND DISCUSSION OF FINDINGS

Table 1. Descriptive Statistics

	KAM	FS	AUDF
Mean	0.481393	9.197861	5.762301
Median	0.5	9.225038	5.4119
Maximum	0.667	10.55278	8.612784
Minimum	0	8.118484	4.518514
Std. Dev.	0.1537	0.492042	1.214308
Skewness	-1.25144	-0.03901	1.757253
Kurtosis	5.059896	4.327773	4.620937
Jarque-Bera	12.25878	9.06391	17.47572
Probability	0.002178	0.035631	0.00016

Source: Researchers compilation (2019)

The descriptive statistics of the data is presented in Table 1. As observed, KAM has a mean value of 0.4813 which suggest that disclosure of KAM in Nigerian bank using the index methodology developed for the study is still not robust as it is around average. Though this is quite understandable given that KAM disclosurejust began in 2016 as the new IAASB audit standard ISA 701 'Communicating Key Audit Matters in the Independent Auditor's Report', was published in January 2015 and is effective for audits of financial statements ending on or after December 15, 2016. Hence companies need time to adjust as is always the case with compliance of disclosure standards, especially in the early stages. The maximum and minimum KAM scores stood at 0.667 and 0 respectively. The mean for Firm size (FE) measured as the log of total assets is 9.197 with maximum and minimum values of 10.552 and 8.118 respectively with a standard deviation of 0.4920. The mean Audit fee presented in the log is 6.762 with maximum and minimum values of 8.6127 and 5.4119 respectively with a standard deviation of 1.214. The Jacque-bera statistics for all the variables have their p-value <0.05 and this implies the normality of the series and the absence of significant outliers.

Table2. Pearson Correlation and VIF scores

	KAM	FS	AUDF	VIF
KAM	1			1.73
ROE	-0.10562			1.05
FS	0.106995	1		1.12
AUDF	0.104594	0.345514	1	1

Source: Researchers compilation (2019)

From table 4.3, the correlation coefficients of the variables are examined. However, of particular interest to the study is the correlation between the dependent variable (KAM) and the independent variables. As observed, KAM is positively correlated with FS (r=0.1069) and AUDF (r=0.1046). Though providing some level of insight into the degree and direction of relationship between the variables, the correlation analysis is limited in its inferential ability mainly because it does not imply functional dependence and hence causality in a strict sense and regression analysis is better suited for this purpose.

Table 3. Regression Result

Variable	Aprori Sign	Fractional Regression
C		-50.6017* (0.3034) {0.129}
AUDFE	+	0.9522 (0.4316) {0.032}
FSIZE	+	0.0023 (0.6231) {0.997}
ROE	+	0.4756 (0.30341) {0.129}
R^2		
Pseudo R^2		0.1196
f-stat		11.96
Prob		0.012
serial corr.	0.893	
B-G for Hetero.	0.554	
Ramsey Reset test	0.410	
Hosmer-Lemeshow		0.840
Likelihood ratio		36.40
Prob		0.000

Source: Researchers compilation (2019)

The FRM overcomes many limitations of established linear econometric solutions and has been extensively used in economics and public policy. The model parameters of the fractional regression estimation, shows pseudo R^2 of 11.96%. The Pseudo R^2 values are typically smaller than what is seen for linear regression models (Norusis, 2005).In many cases, the pseudo R^2 is small even when the model is adequate for the data. The Hosmer–Lemeshow test has a p-value of 0.840 which indicates a good fit to the data and likelihood ratio is also significant as p-value <0.05 and thus confirms that the given model with independent variables was more effective than the null model.

The analysis of coefficients reveals that AUDFE is positive (0.9522) and significant at 5% (p=0.032), this result suggests that the independent variable audit fee explains the firm's ability to disclose KAMs as corroborated in the studies of Hong, David and David (2019) andRice and Weber (2012). Hence, we reject the null hypothesis. Similarly, the firm size also reported a positive effect (0.0023) though not statistically significant at 5% (p=0.997) suggesting that an increase in the firm size may not necessarily affect a firm propensity to disclose KAM. The finding of positive and non-significant relationship is still open to further empirical evaluation.

Conclusion

Following the study's review, expanding audit report by increasing audit communication has some benefit and challenges to the firm. Given this assertion, we deduce that disclosing critical or key audit matters will be dependent on a couple of firm characteristics. However, from the study's estimation, we conclude that the firm size and audit fee affects a firm propensity to disclose key audit matters. However, the firm size may not be considered a strong driver given our findings of a non-significant relationship. Finally, in extending audit reports, organisations should ensure that the objective of credibility and transparency is achieved. This will enhance the quality of audit report.

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