

## **Insight of ISA 701: Key Audit Matter Disclosure in Extended Audit Report**

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### **Abstract**

This review aims to present a comprehensive review of ISA 701 and relevant research on the disclosure of Key Audit Matters (KAM) in extended audit reports. This article is organized into five main streams: (1) Identification of Key Audit Matters; (2) Communication of ISA 701 regarding KAM; (3) The Informative Value of KAM; (4) Types of disclosed KAM; and (5) Opportunities and challenges related to KAM disclosure. The paper highlights the importance of KAM, emphasizing its benefits in enhancing transparency, reducing information asymmetry, improving decision-making processes, increasing the value relevance of information, and reinforcing stakeholder accountability. Conversely, it acknowledges the weaknesses and challenges associated with inconsistent disclosure of KAM, which may jeopardize users' investment decisions and potentially threaten financial statement users. This situation could result in heightened audit time, costs, and potential legal liabilities to auditors. The study contributes to the existing literature by summarizing and analyzing prior research findings. It offers insights into how the disclosure of Key Audit Matters (KAM) can impact audit quality, financial reporting, and the decision-making process for various stakeholders.

**Keywords:** ISA 701, Key Audit Matter, Extended Audit Report, Informative Value, Challenges.

### **Introduction**

The auditor's report serves as an essential outcome of the auditing process, acting as a primary means of communication between auditors and their clients. This report expresses the auditor's opinion on the audited financial statement. However, critics argued that this traditional audit report format failed to effectively convey the value and depth of the auditor's work, resulting in a perceived lack of transparency and relevance. To address these concerns, revised Auditor Reporting Standards ISA 701 were introduced in December 2016 (Coram & Wang, 2021). One noteworthy change stemming from the adoption of ISA 701 is the inclusion

of Key Audit Matters (KAM) disclosure (Abdullatif & Al-Rahahleh, 2020; Coram & Wang, 2021; Gold et al., 2020; Mihret et al., 2022; Pinto et al., 2020; Segal, 2019).

The IAASB defines KAMs in the ISA 701 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, key audit matters are selected from matters communicated with those charged with governance" (IAASB, 2015). ISA 701 mandates the communication of KAM for audits of listed corporations (IAASB, 2015). Additionally, auditors are required to identify and report risk-related issues based on their professional judgment (Elmarzouky et al., 2022). This revision in audit standards enhances the sensitivity with which auditors examine risk issues, such as concerns about fair value estimates and impairments of goodwill and intangibles (ACCA, 2018; Suttipun & Swatdikun, 2021). Moreover, introducing KAMs is expected to encourage managers to provide more comprehensive risk-related information (Sierra-García et al., 2019).

Introducing KAMs is a way to improve auditors' effectiveness in communicating financial reporting risks (Elmarzouky et al., 2022; Nguyen & Kend, 2021). By explicitly identifying and explaining KAM, auditors can provide stakeholders with a clearer understanding of the significant challenges and uncertainties faced during the audit process. KAM enables users, such as investors or analysts, to better understand financial statements and high-risk sectors due to the additional explanations provided (Camacho-Miñano et al., 2023). The detailed insights offered by KAMs contribute to a more comprehensive of critical aspects within the audited entity. The extended audit report with KAM was designed to enhance the usefulness of auditor reports, improve audit quality, and increase auditors' accountability and authority over management (Reid et al., 2019).

The demand for KAM disclosures heightens auditor accountability, transparency, and responsibility in financial reporting (Kitiwong & Sarapaivanich, 2020). It gives auditors the authority to address and report on high-risk areas even when management might prefer otherwise. However, auditors may face confusion regarding whether to declare or delay KAMs, and recommendations in ISA 701 may lead to overly broad identification of KAMs, potentially compromising the intended goals of the audit report (Pinto et al., 2020; Hegazy & Kamareldawla, 2021). Besides, ISA 701 restricts auditor disclosures to a small number of significant matters, limiting the scope of communication (Hegazy & Kamareldawla, 2021).

Research conducted by the Association of Chartered Certified Accountants (ACCA, 2018) suggests that the disclosure of KAM contributes to improved company governance, reporting, and overall audit quality. This implies that providing explicit details about significant audit matters enhances the overall transparency and quality of financial reporting. The United Kingdom was among the first European Union countries to implement a KAM standard (Sierra-García et al., 2019). The Financial Reporting Council (FRC) in the UK published ISA 701 in June 2016, which became effective for audits of financial statements beginning on or after June 17, 2016. According to Asare and Wright (2017), auditors in the UK expressed satisfaction with the results of using ISA 701. They noted that the standard led to more precise and detailed audit reports, indicating a positive reception and perceived effectiveness of the standard in practice.

Meanwhile, In the United States, the Public Company Accounting Oversight Board (PCAOB) instituted a standard known as AS 3101, titled "The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion" (PCAOB, 2017). This standard requires the disclosure of Critical Audit Matters (CAMs) for large companies'

financial statements ending on or after June 30, 2019, and for all other companies' financial statements ending on or after December 15, 2020.

KAM and CAM are very similar (Gold & Heilmann, 2019; Kitiwong & Sarapaivanich, 2020; Rautiainen et al., 2021). Both involve the explicit disclosure of significant audit matters to provide stakeholders with a better understanding of the audit process. Disclosure of KAM or CAM is suggested to serve as an early warning sign of potential misstatements, potentially reducing auditor liability judgments when misstatements are revealed (Bédard et al., 2016; Zeng et al., 2021). This emphasizes the role of KAMs in enhancing the detection and management of financial reporting risks.

### **Identification of Key Audit Matter**

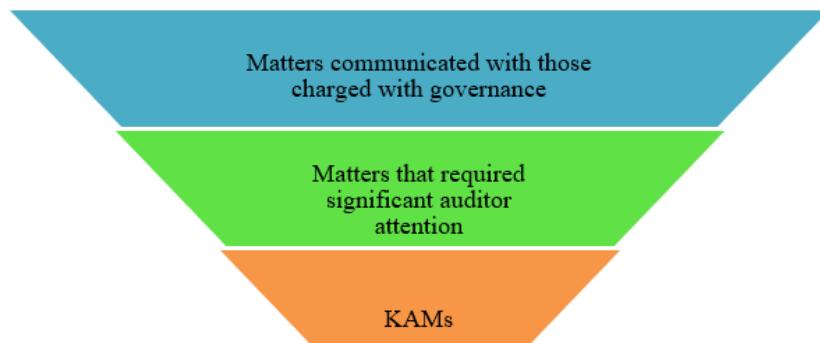
The identification of KAM follows a structured three-step process outlined in ISA 701. In the first phase, auditors are required to identify all issues that have been noticed or discussed with individuals responsible for overseeing the organization. This initial step ensures that the auditor is aware of and considers all relevant issues that may impact financial reporting. The second phase involves the auditor determining which of these identified issues require attention or are deemed important. This determination is guided by the criteria specified in ISA 701 (Par: 5). According to this standard, auditors consider various factors during this determination process. These factors are not explicitly mentioned in the provided text but are typically related to the significance, complexity, and risk associated with the identified matters. The intention is to focus on issues crucial to stakeholders' understanding of the financial statements and requiring special attention from the auditor. By employing this structured approach, the external auditor aims to enhance the transparency and clarity of the audit report, ensuring that users gain valuable insights into the critical aspects of the audit process and the associated financial reporting risks (Baatwah et al., 2022; Li et al., 2019). Ultimately, the disclosure of KAM contributes to a more informative and meaningful communication between auditors and stakeholders. In the third step of the KAM identification process, the auditor makes a selection from the previously identified important matters. As outlined in ISA 701.A29, this selection may be influenced by factors such as the complexity of the accounting standard, which may require additional deployment of resources and services for the audit. The complexity of certain accounting standards can demand a more in-depth and resource-intensive audit process. Consequently, auditors may choose to highlight these specific matters as KAM in the external audit report to draw attention to their significance and the additional scrutiny applied during the audit. Other considerations in determining the relative importance of a matter include:

1. Importance of the issue to the intended users' comprehension of the financial statements as a whole and its materiality to the financial statements.
2. Accountability policy's underlying nature, complexity, or subjectiveness in management's choosing.
3. Nature and materiality of corrected and uncorrected misstatements related to the matter.
4. Nature and extent of audit effort needed to address the matter.
5. Nature and severity of difficulties in applying audit procedures or obtaining relevant and reliable audit evidence.
6. The severity of any control deficiencies related to the matter.

Reducing the significant matters presented in the auditor's report to KAM will prevent information overload for the annual report's reader. The identification processes outlined in

ISA (701.9) and (701.10) should be regarded as guidance for auditors. Ultimately, the auditor's professional judgment determines whether issues are included in the report. Figure 1 below illustrates the procedure that the auditor used to identify KAM.

**Figure. 1 – The procedure that the auditor used to identify KAM**



Source: (IAASB, 2015)

### Communication of Key Audit Matters

Following an understanding of the process for identifying the most crucial audit matters, it is also critical to understand the IAASB's reporting requirements. The auditor is required to include KAM in a separate section of the auditor's report if KAM is identified during the audit process. KAM or its official translation should be used if the report is not written in English for this part (IAASB, 2015). A definition of KAM and a brief description of the identification technique should be given at the beginning of the KAM as an element of the auditor's report (Kitiwong & Sarapaivanich, 2020). This material is meant to assist the reader in understanding the objective of the KAM report. Each KAM is typically marked with a relevant heading (KPMG, 2017). Additionally, the auditor must refer to the specific financial statement, noting the respective KAM impacts. This practice ensures that stakeholders can quickly locate and correlate the information provided in the KAM section with the relevant details in the financial statements (IAASB, 2015).

Information about the risk-oriented audit approach, including the audit methodology, must be provided after a detailed explanation of the KAM. This arrangement ensures that stakeholders receive a comprehensive understanding of the significant audit matters and the approach employed by the auditor to address risks. This standardized format of KAM reports makes comparing data across different reports more accessible (IAASB, 2015). While there may be a predetermined framework for KAM reports, the content and themes within each report should be tailored to the specific needs of the respective company. Auditors can exclude KAM from communications in the presence of extraordinary circumstances (Chen et al., 2020; Coram & Wang, 2020). However, a rationale for excluding a known KAM must be provided even in such cases. This justification may come from legal or regulatory limitations or the auditor's professional judgment that disclosing the KAM's potential adverse outcomes outweighs the public advantages (IAASB, 2015). If, upon assessment, the auditor determines that no KAM needs to be conveyed, a statement to this effect must be included in the KAM section of the auditor's report, as specified by IAASB guidelines. The disclosure of KAM in the auditor's report does not replace a changed opinion. In other words, identifying and disclosing KAMs should not be misunderstood as altering the auditor's overall opinion of financial statements (Bédard et al., 2019; Velte & Issa, 2019).

**The Informative Value of Key Audit Matters**

Due to the new requirement to disclose KAM, the International Auditing and Assurance Standards Board (IAASB) considered it a significant improvement in the quality of financial reporting (Altawalbeh & Alhajaya, 2019). Furthermore, financial statement users show a heightened interest in the KAM section of the auditor's report compared to other non-KAM disclosures (Sirois et al., 2018). The publication of KAMs highlights notable auditor risk factors and makes such firm-specific information readily accessible to the public at a minimal additional cost (Baatwah, 2022). Moreover, the disclosure of KAM is expected to provide further information to investors, enhance the communication value of audit reports, and aid external stakeholders in better understanding the company (IAASB, 2015). Although KAMs attract users' attention and make related disclosures more visible, an increase in the number of KAMs may diminish the effectiveness of their signals (Li et al., 2019). Nevertheless, the IAASB anticipated that at least one KAM would be included in the auditor's report (IAASB, 2015). Anticipated to be diverse and tailored to each organization and sector, KAMs are expected to vary among different sectors due to factors such as opacity, complexity, agency conflicts, and individual and group risk exposure inherent to specific businesses (Al Lawati & Hussainey, 2022; Pinto and Morais, 2019).

Past studies have yielded inconclusive findings on the usefulness of KAMs for users and shareholders. According to Köhler et al (2020), KAMs affect non-professional investors' investment decisions. They realize that experienced investors consider KAMs reliable predictors of a company's financial health. Moroney et al (2021) state that investors benefit more from an audit when KAMs are reported than when not. Additionally, studies have shown the impact of KAM disclosures on auditor and manager behavior. Gold et al (2020) found that the presence of KAMs in the audit report leads to less aggressive financial reporting by managers. In addition, they attribute this conclusion to the idea that the openness of KAMs enhances the accountability pressure on managers, as they anticipate that their actions will be scrutinized more closely in the presence of KAMs and an improvement in audit quality. This aligns with Barghathi et al (2021), who report that implementing KAM enhances audit quality, thereby reducing earnings management.

Moreover, Ma et al (2020) found that the requirement to disclose KAM diminishes auditors' perceived accountability to users. When management disclosures involve high uncertainty, auditor scrutiny is heightened. In a survey of European auditors, Rautiainen et al (2021) discovered that KAM has facilitated increased cooperation between auditors and managers, thereby improving the efficiency of the audit process. Asbahr & Ruhnke (2019) reported that adopting the KAM reporting structure enhances external auditors' adherence to the accounting practices selected by clients. Ozlanski (2019) asserts that the influence of Key Audit Matters (KAM) on investors' views regarding the credibility of management's reporting becomes evident when a specific accounting standard regulates the disclosure of KAM. In a related context, Porumb et al (2021) found that the presence of KAM is associated with a reduction in the tenure of loans and an extension of maturity periods for loan facilities in firms that have adopted KAM, as opposed to non-adopting firms in the United Kingdom. Nevertheless, Boolaky & Quick (2016) discovered no evidence that including KAMs in audit reports influenced the credit-granting decisions or evaluations of a company's financial reporting quality by bank loan officers.

### Types of disclosed Key Audit Matter

The significance of disclosing KAM is contingent on the materiality of the reported item, as indicated by its monetary value (Abdullatif & Rahahleh, 2020). Audit reports encompass a variety of KAM, and the specific type mentioned below is recognized among the Top 10 KAM based on findings from previous studies (Kitiwong & Sarapaivanich, 2020; Chen et al., 2020; Coram & Wang, 2020; KPMG, 2017; Deloitte, 2017; ACCA, 2018):

1. *Revenue Recognition (REV)*: Addressing complex or judgmental aspects related to revenue recognition in the financial statements.
2. *Impairment of Assets (IMPA)*: Evaluating the carrying value of assets and potential impairments, especially in cases of economic downturns.
3. *Going Concern Assumption (GC)*: Examining the entity's ability to continue operations for the foreseeable future, especially in challenging economic conditions.
4. *Acquisition (ACQ)*: Examining the accounting treatment and disclosure of significant business combinations.
5. *Investment Valuation (INVES)*: related to investment valuation typically involves significant challenges or complexities in determining the fair value of investments held by a company.
6. *Inventory Valuation (INVEN)*: involves significant challenges or complexities associated with determining the fair value or cost of the inventory held by a company.
7. *Accounts Receivable (AR)*: involves significant challenges or complexities associated with assessing the existence, valuation, and recoverability of the amounts recorded as receivables on a company's financial statements.
8. *Valuation of Intangible Assets (VIA)*: Assessing the methods and assumptions used in valuing intangible assets, such as patents or trademarks.
9. *Financial Instruments (FI)*: Discussing the fair value measurement and accounting for complex financial instruments.
10. *Taxation (TAX)*: Assessing the adequacy of provisions for income taxes and addressing any uncertainties in tax positions.

It's important to note that the specific types of KAMs disclosed can vary across industries and individual audit engagements. The determination of KAMs is influenced by factors such as the entity's industry, size, complexity, and the inherent risks associated with its operations. Additionally, KAMs are identified based on the auditor's professional judgment and consideration of matters most significant to the financial statement users.

### Expected opportunities and challenges of Key Audit Matter disclosure

In the second and third paragraphs of the introduction to ISA (701), there is a discourse on the opportunities that arise with implementing this revised standard. These opportunities are geared towards enhancing the quality of the audit process and reinstating trust in the accounting profession. In brief, these opportunities encompass:

- A. Enhancing the communicative efficacy of auditor's reports is accomplished by providing heightened transparency in the audit process. The KAM report furnishes supplementary information for specific financial statement users, assisting their understanding of issues considered fundamentally significant by the auditor in examining the financial statements for the current period.
- B. Facilitating the communication of significant audit matters can also enhance the understanding of the entity and critical areas of management judgment in the audited financial statements for the intended users. (Reference: Paragraph A1–A4).

C. Promoting increased engagement of management and those accountable for governance entails encouraging further discussions on specific aspects of the organization, its audited financial statements, or the conducted audit.

On the other hand, criticism of KAM raises concerns. Users of financial statements might perceive the auditor's disclosure of KAMs as inconsistent and biased, especially when compared with the issuance of a clean audit report on the same financial statements (Coram & Wang, 2020). This inconsistency can impact users' investment decisions, leading to a loss of confidence in the auditor's reports and fostering the perception of conflicting opinions (Rahaman & Chand, 2022). Additionally, an increase in the auditor-disclosed KAM poses a potential threat to financial statement users, diverting their attention from other critical sections of the auditor's reports (Li et al., 2019; Sirois et al., 2018). Gold et al. (2020) conclude that auditors should carefully consider the number and the specific items mentioned as KAMs in the audit report. The disclosure of KAM by auditors presents a challenge as it contributes to increased audit time and costs. Identifying and reporting these KAMs requires additional processes (Segal, 2019). In the UK, a study by Gutierrez et al. (2018) revealed that fees for audits conducted under the new model, incorporating KAM in the report, increased by 7% compared to the previous retrospective report model that did have KAM. Moreover, concerns about heightened legal liability resulting from the disclosure of KAM have been raised by auditors, as noted by Gimbar et al. (2016). This concern may undermine the intended benefits outlined in ISA 701. Brasel et al. (2016) oppose the idea that the disclosure of principal audit matters serves as a warning to financial statement users, potentially reducing the auditor's litigation risk. Additionally, the auditor's sectoral specialization is anticipated to influence their ability to identify and disclose KAM positively (Pinto & Morais, 2019). On the other hand, the tenure of the auditor's relationship with the client is expected to have a negative impact on the disclosure of KAM, particularly those of a negative nature (Singer & Zhang, 2018).

### Conclusion

In light of substantial critiques directed at the conventional pass or fail audit report model, global standard setters and regulators have introduced updated mandates for auditor reporting. These revisions encompass the obligation for auditors to disclose Key Audit Matters (KAMs). The aim of this research is to analyze ISA 701, focusing on understanding of KAM and its implementation to gain insights into the critical components of KAM which cover its identification, communication, the informative value and common types. Furthermore, this study emphasizes the importance of KAM disclosure on multiple fronts, such as increasing transparency, reducing information asymmetry, improving decision-making processes, enhancing the value-added relevance of information, and strengthening stakeholder accountability. Nevertheless, the study recognizes the risks and challenges inherent in the inconsistent disclosure of KAM. This factor could potentially compromise users' investment decisions. In addition, disclosing KAM may lead to increased audit duration, heightened expenditures, and potential legal obligations for auditors. The study contributes to the existing literature by summarizing and analyzing ISA 701 and prior research findings. It offers insights into how the disclosure of KAM can impact audit quality, financial reporting and the decision-making process. Besides, understanding KAMs could be crucial for investors, regulators, and other parties involved in assessing the financial health and performance of a company. It is hoped that, by offering a thorough comprehension of KAM, it will contribute to the realization of KAM's goal, which is to improve communication between auditors and financial statement users.

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