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IMPACT OF KEY AUDIT MATTERS (KAMs) DISCLOSURE ON AUDIT QUALITY: MALAYSIAN PERSPECTIVE

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Abstract

The audit regulator in Malaysia has recently adopted the new auditing standard, ISA 701, that require the inclusion of key audit matters (KAMs) in the auditor's report for public listed companies (PLCs). The new audit reporting standard became effective for Malaysian PLCs financial statement audits on or after 15th December 2016. This study investigated whether this new expanded auditor's report had consequences on audit quality. The study adopts the financial reporting quality measure, absolute abnormal accruals (ABS_ACC), as a proxy for audit quality. The analysis covers the first year implementation impact of the changes in Malaysia context. Findings of this study evidenced that the new change significantly affected audit quality. Finally, findings of this study are useful for standard setters by highlighting the significant implications for policy and standard setting, given that there are conflicting results as to whether additional disclosure requirements such as the KAMs will beneficial to all targeted parties.

Keywords: Key Audit Matters (KAMs), Audit Quality, Public Listed Companies (PLC's), Malaysia.

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1. Introduction

Auditor's report is the primary communication between a company's auditor and its shareholders. In most countries, and for the massive majority of companies, the auditor's report uses standardized language. Regulator, the International Auditing and Assurance Standards Board (IAASB) had identified that users demand for more information on the auditor's report instead of the established "pass" or "fail" opinion. The new ISA701 intends to highlight the most significant entity-specific issues based on the auditor's evidence and work carried throughout the audit process in order to provide more relevant information to the users of the report (IAASB, 2015). The Standard is developed in order to assist the companies and their stakeholders in better understanding the matters, which according to the auditor's professional judgments were of most significant for that respective period (IAASB, 2015).

In Malaysia, the Malaysian Institute of Accountants (MIA) adopted the equivalent of IAASB's new auditor reporting model (ISA 701), which became effective for audits of financial statements for fiscal year ends on or after 15th December 2016. The biggest change to the auditor's report is the communication of KAMs. The auditor's report is no longer limited to a binary "pass/fail" opinion. The driver for these changes was a demand from users for the auditor to provide more insights about the audit process.

KAMs provide an opportunity to share the matters that, in the auditor's judgement, were of most significance in the audit of the current period financial statements. KAMs are selected from matters communicated with those charged with governance. The auditor is required to identify the KAMs, explain why they are a KAM and justify how the KAM was addressed. The justifications are left to the judgement of the auditor. The auditing standards do not require a lengthy description of the auditor's procedures, nor do they require an indication of the outcome of the procedures. The new report is intended to be less boilerplate and provide more specific, useful and relevant information about the audit of an entity.

2. Problem Statement

The Financial Crisis of 2008 brought into sharp focus the concerns of investors and others about the effectiveness of company stewardship generally and about the effectiveness of the audit in supporting this (The Financial Reporting Council, 2015). In particular, concerns were raised about whether the binary (i.e. pass/fail) auditor's report continued to be fit for purpose in providing adequate transparency about the audit and the auditor's insights about the company (Cooper & Grose, 2010).

Corporate scandals in Malaysia had also knockout auditor's quality in Malaysia. In 2007, two Malaysian listed companies, namely Transmile Group Bhd and Megan Media Bhd have been labelled as a Malaysian mini-Enron financial scandal causing the loss of shareholder funds and delisting from the exchange (Zaimee, 2007). The appointed auditor was criticized for failing to give early signal on any unusual transactions in these two companies (Hamid et al., 2013). Next, the most recent case of the 1Malaysia Development Berhad (1MDB) had again make public questioned on the reliability and quality of auditors in Malaysia. On January 2019, the Securities Commissions of Malaysia (SC) imposed RM2.2 million penalty on Deloitte (one of the big four audit firms in Malaysia) for failing to discharge its statutory obligations, including not immediately reporting irregularities in its audit (Ying, 2019).

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Urged by all these issues, the investment community in Malaysia has been calling for greater transparency from auditors to give users of financial statements more insights into the audit and the auditor's roles (SC, AOB, MIA, & ACCA, 2018). Therefore, for this reason, a new section in the auditor's report called KAMs will highlight those matters that, in the auditor's professional judgment, were of most significance in the audit (Boonyanet & Promsen, 2017).

Having said that, there is no evidence so far that requiring auditors to add additional information will increase the value of the audit report information, thus improve audit quality. Practitioners and academics challenge the rationale for the addition of key audit matters to audit report, and they doubt that KAMs may become models over time (IAASB, 2012). Nevertheless, there are some literatures believed that the new audit reporting requirements are likely to increase auditor's accountability and professional scepticism, which will result in improved audit quality (Li et al., 2019; Peecher et al, 2013). Others suggest that the new audit reporting requirements may impose additional pressure on auditors, thus have an adverse effect on audit quality (KPMG, 2015).

Therefore, based on the different findings, this study aims to examine the costs and benefits associated with the recent audit reporting changes in the Malaysian context. Specifically, this study documents the impact of the reporting changes on audit quality (proxied by the absolute value of abnormal accruals

3. Research Questions

Do the KAMs disclosure in the auditors' report affect audit quality?

4. Purpose of the Study

The purpose of this study is to investigate the impact of KAMs disclosure in the auditors' report on audit quality for Malaysia context.

5. Research Methods

This study starts with all 434 Malaysian PLCs available in Main Market on Bursa Malaysia database with financial year ended at 31 December 2016 being the first companies compulsorily implement KAMs. Of these, 97 companies were rejected due to unavailability of data. Hence, the final sample for this study consisted of 337 PLCs. The rest of the data used for the study were retrieved from the Thompson Reuters Eikon database and each company's website.

This study adopted the financial reporting quality measure, absolute abnormal accruals (ABS_ACC), as a proxy for audit quality as the dependent variable. The abnormal accruals have widely been used as a measure of earnings quality that represent the audit quality (Becker et al., 1998; Carcello & Li, 2013; Francis et al., 1999; Li, 2017; Li et al., 2018; Reid et al., 2016). Discretionary accruals can be calculated using several types of measurements such as using an absolute value, a signed value, the Jones model, the modified Jones model, and or the performance matched models. This study adopted the performance matched modified Jones model as suggested by Kothari et al. (2005).

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The following model was developed to examine the relationship between the disclosures of KAMs and audit quality.

ABS_ACC = β0 + β1KAM + β3PROF + β4LEV + β5SIZE

This study predicted KAM to be negatively correlated with ABS_ACC. The study also used control variables such as profitability (PROF), leverage (LEV) and size (SIZE) based on previous findings (Li et al., 2018; Reid et al., 2015). Table 1 presents the measurements of variables used for this study.

Table 01. Measurement of Variables

Variables	Measurement
KAM	1 = 1 to 3 KAMs disclosed 2 = 4 to 6 KAMs disclosed 3 = 7 to 9 KAMs disclosed
ABS_ACC	Absolute Value of Abnormal Accruals
PROF	Net income divided by the total asset
LEV	Debt to Equity
SIZE	The natural logarithm of total assets at the end of year t

6. Findings

The results of the abnormal accrual analysis are presented in Table 2. The Adjusted R2 of the model is 0.762, which means that this model explains 76.20% of the variance in ABS_ACC using KAMs, profitability, leverage and firm size. The value of Adjusted R2 of this study indicated a higher value as compared to abnormal accrual analyses in past literature by Li et al. (2018) with Adjusted R2 of 0.298, by Gutierrez et al. (2018) with Adjusted R2 of 0.180 and by Li (2017) with Adjusted R2 of 0.475. The result shows that this research model is more favourable and fit the data well as compared with those from previous literatures.

Table 02. Multiple Regression Results of KAMs on Audit Quality

	ABS_ACC	
Dependent Variable	**β**	**t-stat (p-value)**
(Constant)		-0.275 (0.784)
KAM	-.004	-2.121 **(0.035)****
Prof	-.010	31.924 **(0.000)*****
Lev	.510	0.832 (0.406)
Size	.008	.590 (0.556)
F-stat/ (F-stat Sig.)	270.132 / **(0.000)*****	
Adjusted R2	0.762	

Note: ***= 1% level of significance **= 5% level of significance

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The F statistic for this model shows that this regression model is fit and significant (Fstat = 270.132, p < .01). The unstandardized (ß) coefficient for this equation is -0.04. The results of this study show that the coefficient of KAMs shows a significant impact to the ABS_ACC (ß= -0.04, p-value > 0.05), indicating that KAMs disclosure negatively impact the abnormal accruals of Malaysian PLCs. The more KAMs disclosed in the audit report will result to the reduction of absolute value of the abnormal accruals, therefore improved the audit quality of Malaysian PLCs. The result is in line with previous study by Li et al. (2018), where the coefficient of KAMs shows significant impact to the ABS_ACC (ß= -0.143, p-value < 0.01). The result also supported a study by Reid et al. (2016) as the study result provides evidence that abnormal accruals significantly decreased after the new auditor disclosures and it appears that financial reporting quality had improved under the new reporting regime.

Regarding the control variables, the coefficient of profitability shows a positive and significant (ß= 0.51, p-value < 0.01) to the abnormal accrual analysis while coefficient for leverage (Lev) and firm size (Size) shows insignificant impact to the abnormal accruals (ß= 0.008, ß= 0.002, p-value > 0.05, p-value > 0.05 respectively). This shows that the higher profitability result to a higher abnormal accrual which indicated that the audit quality had decreased.

This result is contradicted with previous literature as the high profitability result to lower abnormal accruals thus improved audit quality (Li et al., 2018; Reid et al., 2016). For firm size, this study also disclosed a different result where firm size brings no impact to the audit quality of Malaysian PLCs. Previous studies have proved that firm size negatively impact to abnormal accruals thus has improved audit quality (Gutierrez et al., 2018; Li et al., 2018; Reid et al., 2016). Finally, for leverage, the result of this study is in line with previous literature as it brings no impact to the audit quality (Gutierrez et al., 2018; Li et al., 2018; Reid et al., 2016).

7. Conclusion

The new requirement for disclosure of KAMs in the auditor’s report is introduced in order to meet the capital market demand for high-quality accounting information and improve the quality of audit reports. This study investigates the impact of the reporting changes on audit quality. Using a balanced sample of Malaysian PLCs, the study documents that upon the adoption of the new audit reporting regime, audit quality has improved (as proxied by a reduction in absolute abnormal accruals). These findings support the argument that the new audit reporting standard have achieved its intended benefit of increased audit quality.

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