

Key Audit Matters in Enhanced Auditor's Report: Tracing Malaysia in Its First Year Implementation

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Abstract – This study aims to explore Key Audit Matters (KAMs) contained in the independent auditor's report according to the latest International Standards on Auditing (ISA) rule—Enhanced Auditor's Reports (EAR). In addition, we illustrate how the experience of neighboring country—Malaysia, which has adopted Enhanced Auditor's Report (EAR), to obtain an overview of the prospect of implementing this rule in Indonesia. We collect and analyze articles related to the topics published from 2015 to 2018. Based on literature review, we can conclude that Key Audit Matters (KAMs) are substantial for investors, managements, and auditors. Malaysia as one of the countries that adopt Enhanced Auditor's Report (EAR) shows a positive change in its first year implementation. Reflecting on this neighboring country, The Indonesian Institute of Certified Public Accountants (IAPI) as the responsible party for the preparation and determination of *Standar Audit* (audit standards that apply in Indonesia) should immediately take actions to adopt Enhanced Auditor's Reports (EAR) to receive many benefits of Key Audit Matters (KAMs).

Keyword - Key Audit Matter, Auditor's Report, Standar Audit, International Standards on Auditing, ISA 701.

I. INTRODUCTION

Audit reports are a bridge of communication between the auditor and the user and in many cases, the only contact the user has with the auditor (Libby, 1979 in Dogan and Arefaine, 2017). The users of financial statements will rely on the auditor's report to obtain reliability from the financial statements issued by the company so that the auditor should carry out a series of correct audit processes before arriving at a conclusion stated in the audit report.

In a standard audit report, the auditor provides a brief description of the audited area, and shows whether the audit report meets the requirements (financial statements are fairly and appropriately presented) or does not meet the requirements (financial statements presented as unfair and inappropriate) [Carrington, 2014 in Dogan and Arefaine, 2017]. However, the public has criticized the auditor for using language that is too standard, because they do not explain how they have reached the opinions they gave in the audit report, and because they do not communicate adequately with the people they have to protect—shareholders and potential investors (Corodos and Fulop, 2015). Audit reports only communicate a little information obtained during audit engagements (PCAOB, 2016).

Responding to criticism of auditor reporting standards, the International Federation of Accountants (IFAC) through the International Auditing and Assurance Standard Board (IAASB) decided to revise some of the rules of International Standards on Auditing (ISA). IAASB have issued new standards in January 2015, called ISA 701—communicating key audit matters in the independent auditor's report. This rule applies internationally and effectively implemented for financial statement audits for the period ending or after December 15, 2016 (Dogan and Arefaine, 2017).

Key audit matters (KAMs) are those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period (IAASB, 2016). The auditor should communicate with Those Charged with Governance (TCWG) to choose things as Key Audit Matters. It is substantial because KAMs inform users of audit opinions in sensitive key areas in the audit process, which were previously limited to discussion with management.

Extensive changes made in the preparation of the auditor's report establish the report more transparent and informative. Implementation of this standard will encourage the flow of useful and relevant information to the capital

market, reduce speculation about company performance and encourage understanding of financial statements (AOB, MIA, and ACCA; 2018).

Unfortunately, Indonesia still has not implemented the latest ISA's rule regarded to the independent auditor's report— hereinafter referred to Enhanced Auditor's Report (EAR). The Indonesian Institute of Certified Public Accountants (IAPI) as the responsible party for the preparation and determination of *Standar Audit* (auditing standard in Indonesia) still adopts ISA 2010 and other IAASB statements in 2012, specifically regarded to auditor reporting. At present IAPI is still focusing on reviewing and translating the latest versions of ISA and other IAASB statements, exposing them to public consultations, looking for standard approval, and disseminating standards to members. Although IAPI initially planned to complete adoption and translation of all standards in 2015, the process has been delayed to date (www.ifac.org).

Referring to this issue, we conduct this study to explore Key Audit Matters (KAM) contained in Enhanced Auditor's Report (EAR). In addition, we illustrate how the experience of neighboring country—Malaysia, which has adopted

Enhanced Auditor's Report (EAR) to obtain an overview of the prospect of implementing this rule in Indonesia.

II. RESEARCH METHOD

This research is a literature review by examining articles related to the topic published from 2015 to 2018. The discussion of various literature will be presented in several sections as explained later.

III. LITERATURE REVIEW AND DISCUSSION

3.1 Standar Audit (SA) vs International Standards on Auditing (ISA): Review of Audit Reports

Comparisons between Standar Audit (SA) applied in Indonesia and the latest version of International Standards on Auditing (ISA) applied in Malaysia related to independent auditor's reports are as follows:

3.1.1 SA vs ISA Structure Rules

Structurally, there are some differences between SA and ISA. Indonesia still has not implemented new rules and revised rules issued by ISA in 2015. Following the differences:

Table 1. Comparisons Between SA vs ISA Structure Rule

Section	Title	SA in Indonesia	ISA in Malaysia
SA 700 ≈ ISA 700	Forming an opinion and reporting in financial statements	Not revised yet	Revised
ISA 701	Communicating key audit matters in the independent auditor's report	Not adopted yet	Adopted
SA 705 ≈ ISA 705	Modification to the opinion in the independent auditor's report	Not revised yet	Revised
SA 706 ≈ ISA 706	Emphasis of the matter paragraphs and other matter paragraphs in the independent auditor's report	Not revised yet	Revised
SA 710 ≈ ISA 710	Comparative information—corresponding figures and comparative financial statements	Adopted	Adopted
SA 720 ≈ ISA 720	The auditor's responsibilities relating to other information in documents containing audited financial statements	Adopted	Adopted

3.1.2 SA vs ISA Auditor Reports Format

In appearance, the standard auditor report format currently used in Indonesia as different from the new

standard auditor report format set by ISA as used in Malaysia. Following the differences:

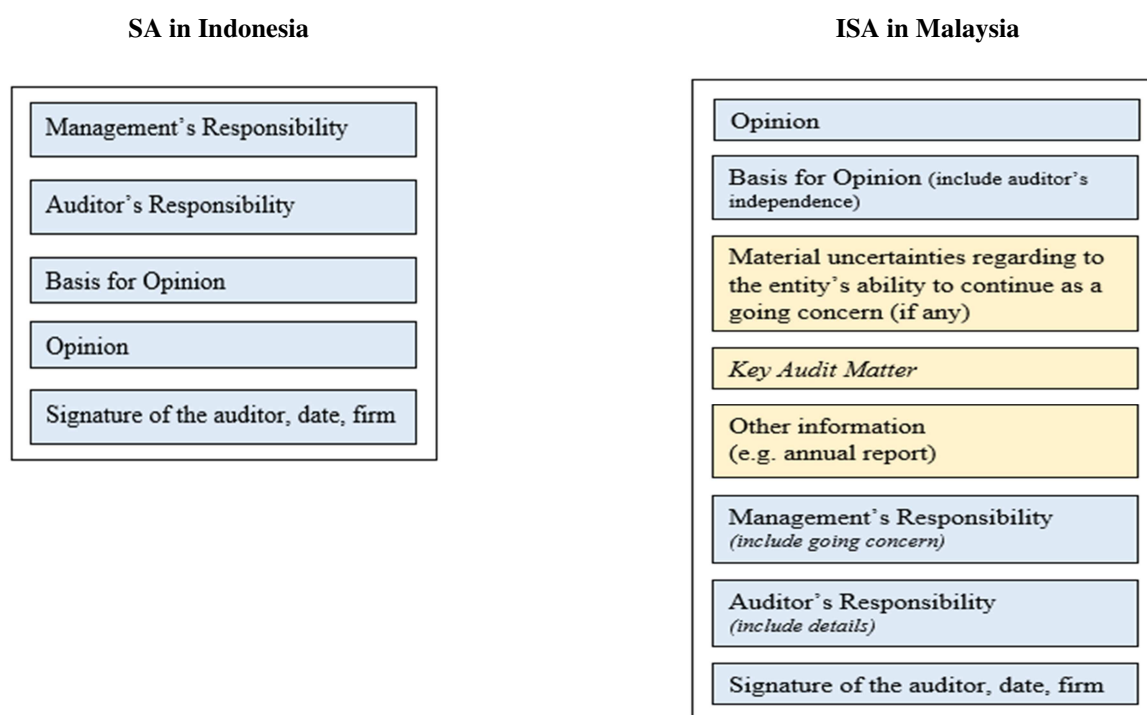


Fig. 1. Comparisons Between SA vs ISA Auditor Reports Format

3.2 The Content Analysis of Enhanced Auditor's Report (EAR)

Based on the latest rule set by The IAASB (2015), there several key enhancement in Enhanced Auditor's

Report (EAR) to provide greater transparency to users. Following the content analysis of the new independent auditor's report:

Table 2. The Content Analysis of Enhanced Auditor's Report (EAR)

Required for	Explanations
Listed entities and voluntary application for non-listed entities	- A new section for communicating key audit matters (KAM). - Disclosure engagement partner' name, with a "harm-way" exemption.
All entities	- The opinion section must be presented first, followed by the Basis for Opinion section, unless the law or regulation define otherwise. - Enhanced Auditor's Report on going concern (GC), including: - Description of management and auditor's responsibilities for GC; - A separate section when material uncertainty exists, and is sufficiently disclosed, under the heading "Material Uncertainty Related to Going concern"; - New requirements for the adequacy of disclosures for "close calls" when events or conditions that are identified may cast significant doubts on the entity's ability to continue as a GC. - Explicit statements about auditor's independence and fulfillment of relevant ethical responsibilities. - Enhanced the description of the auditor's responsibilities and the main features of the audit, together with the provision that certain components of this description, may be presented in an appendix of the auditor's report or, where law, regulations or national auditing standards explicitly permit, by reference in the auditor's report to a website of an appropriate authority.

3.3 Empirical Research Results Related to the Impact of the Implementation of Enhanced Auditor's Report for Auditors, Clients, and Investors

Changes in the latest ISA rules about auditor's report certainly have an impact on various parties involved. Academic studies that have emerged since the regulation issued by the IAASB are mostly related to the impact and consequences of the application of ISA 701—communicating key audit matters (KAMs) in Enhanced Auditor's Report (EAR) for auditors, clients, and investors.

3.3.1 Impact of the Enhanced Auditor's Report for Auditor

Related to the impact of KAMs on audits, Bedard, Besacier, and Schatt (2015) found that there was no significant effect on audit costs and audit report lag. The results of this study were in line with the results of the research of Almulla and Bradbury (2018) which found that although the number of KAMs related to audit costs, both in the first year of KAMs reporting and in the previous year, there was no evidence that KAMs reporting in the first year resulted higher audit costs. That is, the client may not want to pay for KAMs disclosures and the auditor may issue this fee from the audit fee profit margin. KAMs also deal with audit delay, but with weak associations. This is possible because the sample size is not enough and there are other pressures on the client and public accounting firms for timelier reporting. In addition, the results of this study also revealed that there was no significant relationship between KAMs and audit quality.

Dogan and Arefaine (2017) concluded that auditors' willingness to write about specific information in audit reports was limited, for fear of quarreling with their clients and ending with lawsuits. After the KAMs implementation, auditors are also in a higher risk position, because the new standard requires them to write more about what they have reviewed and why; as a logical consequence, they are careful, as they have revealed.

In line with the findings above, the results of Sakel's study (2018) also found that auditors showed assessments and actions that were not significantly skeptical when there was a KAM consideration than when there was no KAM consideration. This result shows that, when considering KAMs and because of moral licensing, auditors are more willing to approve the accounting treatment desired by their clients, believe that KAMs communication provide a defense not to make adjustments, or that KAMs communication fulfill the auditor's primary duty to ensure that the investment community has notified. In addition, the findings revealed that auditors did not show differences in skepticism in terms of their judgments and actions when client pressure is higher or lower.

3.3.2 Impact of Enhanced Auditor's Report for Clients

The findings of Dogan and Arefaine (2017) illustrated that the implementation of KAMs did not affect auditor

relations with clients. This is possible because the auditors have a transparent dialogue with the company about KAMs, and because the auditors are prudent when formulating KAMs. Almulla and Bradbury (2018) found that KAMs companies made more disclosures than non-KAM companies did, both in the first year of KAMs reporting and in the previous year. Klueber, Gold, and Pott (2018) also concluded that KAMs reduced the tendency of managers to engage in earnings management activities, but when the accuracy of information in disclosure was high risk.

Christofferson and Gronberg (2018) revealed that determinants related to audit firm characteristics and company financial characteristics encouraged variations in KAMs disclosures in companies registered in Sweden. There was a large spread in how KAM disclosures, ranging from not specific to very specific. Overall, these findings provided evidence that ISA 701 did not work as expected by the IAASB.

3.3.3 Impact of Enhanced Auditor's Report for Investors

Bedard, Besacier, and Schatt (2015) stated that there were no significant effect of KAMs for investors on abnormal market returns and abnormal trading volumes. Overall, the results of this study indicated that the new audit report adopted in France, even if more detailed, still only has symbolic value and did not provide additional informative value to investors.

Kohler, Sakel, and Theis (2016) found that the KAMs section did not have communicative value for non-professional investors. The researcher concluded that non-professional investors had difficulties in processing the information conveyed in the KAMs section. However, this finding implied that for professional investors, specific information content from the KAMs section had a positive contribution. Christofferson and Gronberg (2018) also stated that KAMs disclosures were only informative to a certain extent. The researchers showed that ISA 701 did not function properly because KAM disclosure does not reflect the company's underlying economy and did not have a high level of specificity.

Contrary to the findings as already explained the results of Dogan and Arefaine (2017) stated that new standards would contribute to reducing the gap in user expectations, because the audit report contained a clearer description of auditor responsibilities. Tudor, Cordos, Fulop (2018) also concluded that an extended audit report, through the addition of the KAMs section, made users more aware of the auditor's mission and objectives, had a better understanding of auditor responsibilities, the level of auditor independence, and the level of assurance they provided. Similarly, Almulla and Bradbury (2018) also found that KAMs were relevant and related to decision making by investors.

In summary, the empirical results show that there are still research gap conducted by researchers in various parts of

the world, so that the researchers can explore deeply about Enhanced Auditor's Report (EAR) in future.

3.4 Malaysia's First Year Experience in Implementing Enhanced Auditor's Report

The Association of Chartered Certified Accountants (ACCA), The Securities Commission Malaysia (SC)'s Audit Oversight Board (AOB), and the Malaysian Institute of Accountants (MIA) work together to explore the impact of the first generation of Enhanced Auditor's Report in Malaysia. This study investigate the experiences and perceptions of two parties on both sides of EAR: audit committees as 'guardians' of the company's financial information (internal parties), and investors who receive, interpret and react to this information (external parties). Some of the main findings from this study include:

3.4.1 First Year Experience of How Auditors Apply the Requirements for KAMs

- **KAM's number reported**

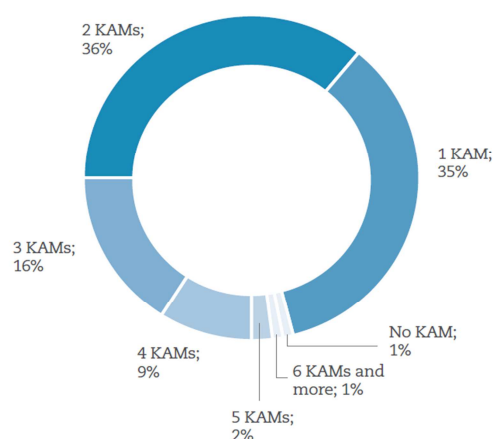


Fig. 2. KAM's number reported

Based on the figure 2, the number of KAMs reported in the EARs range from no KAM to a maximum of six KAMs. The average number of KAMs for each EAR in Malaysia is 2.09.

- **Topics reported in KAMs**

The figure 3 shows the top eight topics covered by the KAMs reported in the first year in Malaysia. The most frequently reported KAMs topics related to revenue recognition (not fraud risk), impairment of receivables, and impairment in goodwill and intangible assets.

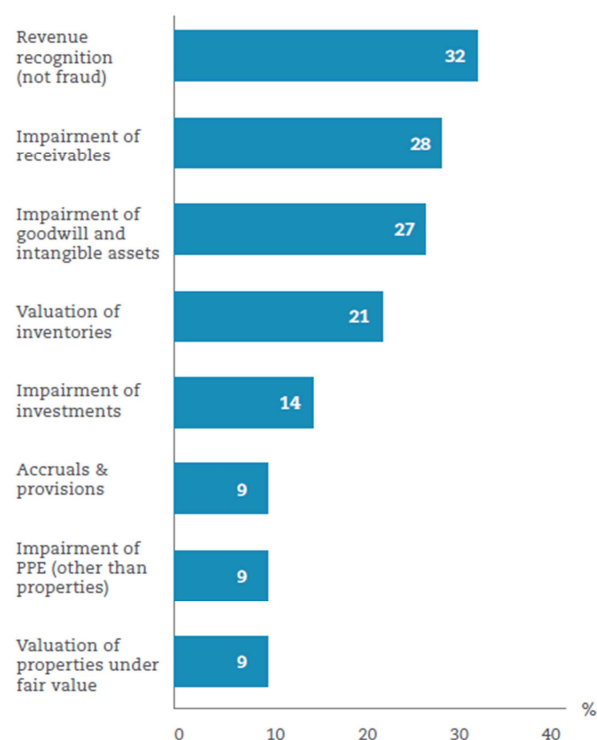


Fig. 3. Topics reported in KAMs

- **Reasons why something identified as KAMs**

The figure 4 shows the reasons for the selection of the 398 KAMs reported by the sample companies, mostly involving significant management judgements. From the review, we know that many KAMs used general descriptions that may not be able to articulate the reasons auditors had judged a matter to be KAM.

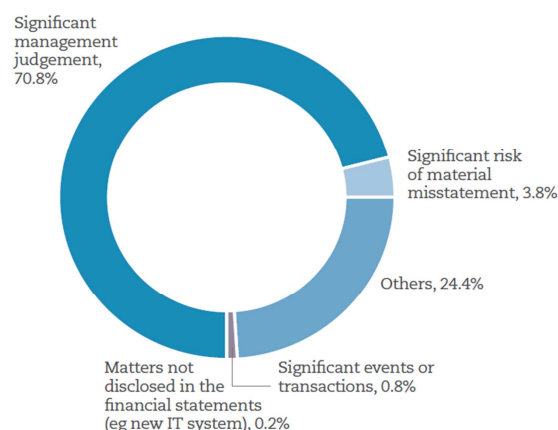


Fig. 4. Reasons why something identified as KAMs

3.4.2 First Year Experience Indicates Positive Change

Implementation of Enhanced Auditor's Report (EAR) give satisfactory result for stakeholders. The following are some of the study's findings indicated that

Malaysia's first year experience in implementing EAR made positive change.

Table 3. Findings indicated first year experiences of EAR made positive change

Subject Matter	Findings
Audit committee discussions about financial reporting risk with auditors and management	85% of audit committee members agreed that they needed to have robust discussion with management and auditors in discussing KAMs. 86% of audit committee members reported that they had gained more insight into corporate financial reporting risk because of considering KAMs and reviewing the EAR.
Investor's insight into the financial reporting risks of the companies they invest in, as well as the audit process	67% of investors surveyed agreed that EAR had helped them to better understand the financial reporting risks of the companies in which they had invested.
The audit process	68% of audit committee members observed an increase in the involvement of audit partners in audits. 84% of this group considered the improvement efforts to be sufficient and 26% who do not observe an increase in involvement by audit partners especially because the involvement of audit partners is sufficient before the implementation of EAR.
Management's efforts to increase disclosures in the annual report, after discussions about KAMs	64% directors and management made improvements to financial statement disclosures while the process of considering KAM and reviewing EAR. 64% directors and management made improvements to other elements in the annual report while this process.
The relevance and value of auditor reports	86% of investors reported that the inclusion of more information in EAR make them more likely to read the auditor's report before the financial statements

IV. CONCLUSION

Independent auditor's report according to ISA's latest version—Enhanced Auditor's Report (EAR) has brought positive changes in user's perception about financial statements. Key Audit Matters (KAMs) contained in EAR is designed to convey company-specific information about the risks of financial reporting.

In particular, better communication from KAMs can facilitate effective engagement between companies and investors. Clearer and more appropriate KAMs will enable greater transparency and in turn, it will contribute positive impact on the company.

Not only has an impact on investors, the implementation of KAMs in EAR also has an influence on the companies and the auditors. The management of the companies should not press the auditor to hide information identified as KAMs. Conversely, the management should support auditor's actions for transparency of reporting which will ultimately affect the value of the company. As the party that has the most role in communicating KAMs, the auditor should denote skepticism and independence during the audit process until the reporting process of EAR, which contains KAMs information.

Reflecting on Malaysia's experience in implementing EAR, Indonesia should readily move forward to follow in

the footsteps of this neighboring country. Various benefits of KAMs felt by all parties still exceed the negative consequences of communicating this information in the independent auditor's report. The longer Indonesia postpones adoption EAR, the more our economy will lag behind compared to countries that have already implemented. Almost foreign investors will surely less interested in investing in local companies because no KAM disclosed. The investor will consider the company as not transparent.

The biggest challenge towards the Enhanced Auditor's Report (EAR) will certainly be in the hands of the auditors, how the auditors carry out the audit process, identify KAMs, and communicate it in the independent auditor's report. Not only that, other factors that influence auditors performance such as client pressure, audit assignment time, audit fees, and other things also become determinants for auditors related to audit reporting.

However, before we think too far about the challenges that auditors will face in the scope of the Enhanced Auditor's Report (EAR), what we really need right now is the role of standard setters. The Indonesian Institute of Certified Public Accountants (IAPI) as the responsible party for the preparation and determination of Standar Audit (audit standards that apply in Indonesia) should immediately take actions to adopt Enhanced Auditor's Reports (EAR) by

reviewing and translating the latest ISA version, exposing it to public consultation, looking for standard approval, and disseminating standards to its members. This adoption is a compulsory for IAPI in order to achieve transparency in the independent auditor's report in Indonesia.

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