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Key Audit Matters versus Financial Indicators: Consistent or Contradictory?

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Abstract

The ISA 700 (Revised) Forming an Opinion and Reporting on Financial Statements has mandated the independent auditors to communicate key audit matters of the audited financial statements to enhance the value of the auditor's reports. This study aims to examine whether the key audit matters identified by the independent auditors are in line with the financial performance indicators derived from the financial information provided in the financial statements. The study uses secondary data obtained from the independent auditor's report and Datastream database. The key audit matters tested in this study are revenue recognition, trade receivable, and inventory issues which are found to be frequently reported in the independent auditor's report. The key audit matters are categorized into groups. T-test is done to analyse the difference in mean of financial ratios between the group that was identified to have key audit matter and otherwise. The result shows significant difference in mean of certain financial ratios between the groups. We found that the key audit matter disclosed is in line with the financial performance indicators. This is supported by the evidence that those firms identified to have trade receivable issue as key audit matter by the independent auditor also show poor performance on average collection period and total asset turnover. On the other hand, the key audit matter related to significant judgements by the auditors in areas of higher assessed risk of material misstatement did not reflect on financial performance indicators. The firms that suffered from revenue recognition and inventory issues performed better according to the financial ratio. The findings of this study provide evidence that the identified key audit matter need to be interpreted according to the nature of issues as there are mixed relationship observed between key audit matters and financial indicators.

Keywords: Audit report, key audit matter, firm's performance, disclosure

1. INTRODUCTION

The role of financial reporting is to provide useful information for users to make economic decisions. However, the users may not have mutual agreement or similar opinion in respond to the same piece of financial information (Scott, 2000). This makes the financial accounting and reporting environment to be complex and challenging (Scott, 2000). Consequently, there is a need for the professional to provide assurance service to help improve the reliability and relevance of the information.

The assurance services provided by the external auditors improve the quality of information for decision makers (Arens, Elder, Beasley, 2003). The independent auditors will issue an independent auditor's report to communicate their opinion and the audit outcomes of the financial statements. This report can be a reliable reference for the investors to assess and evaluate the firm's financial statements from a third party's view. This helps the investors to make better decisions.

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Gómez-Guillamón (2003) concluded that the information presented in the auditor's report is relevant and useful for investment and lending decisions by credit institutions and dealers and brokering companies. This means that the auditor's report still plays an important role in assisting the users of financial statements to make decision. Thus, the uniformity of audit practices and audit reporting is very vital for the users to make comparison among different firms and across different financial years. Previous study by Zhou (2007) also stated that the auditing regulation can permanently reduce the long-run information asymmetry in the capital markets.

On the other hand, the International Audit and Assurance Standards Board (IAASB) is a committee of International Federation of Accountants (IFAC) responsible for setting high quality International Standards on Auditing (ISA) and assurance standards. IAASB imposed new standards, ISA 700 (Revised) and ISA 701 that required the auditors to communicate the key audit matters in the independent auditor's report. Meanwhile, in Malaysia, Malaysian Institute of Accountants (MIA) announced the new ISA 700 (Revised) and ISA 701 standards in April 2015, following the changes made by IAASB. The new standards were effective for financial statements with reporting periods ending on or after December 15, 2016 (Malaysian Institute of Accountants, 2015a). ISA 700 (Revised) states that "for audits of complete sets of general-purpose financial statements of listed entities, the auditor shall communicate key audit matters in the auditor's report in accordance with ISA 701" (Malaysian Institute of Accountants, 2015a).

Key audit matters are defined in ISA 700 (Revised) as those matters that are most significant in the process of audit of the financial statements of the current period. Key audit matters normally involve issues that required significant judgements by the auditors in areas of higher assessed risk of material misstatement, areas involving significant management judgement due to high estimation uncertainty as well as significant events and transactions occurred in the current period (Malaysian Institute of Accountants, 2015b). Thus, they reflect issues faced by the firm. The auditor's responsibilities are to communicate key audit matter in the auditor's report in accordance with ISA 701 (Malaysian Institute of Accountants, 2015a).

However, there is always an expectation gap between the auditor competencies and the investors' expectation. Many users misunderstand the nature of the attest function and tend to mis-interpret the judgement of the auditor in issuing an opinion (McEnroe & Martens, 2001). In the study of Gold, Gronewold, and Pott (2012), the audit expectation gap still exists even the detailed explanation on responsibilities of both management and auditor written in the auditor's report as required by new ISA 700. Thus, under the same perception, the users may interpret the key audit matter in different ways. According to Kachelmeier, Schmidt, and Valentine (2017), the key audit matter disclosure could increase or decrease the perceptions of auditor responsibility for a misstatement. It increases the perception of the auditor responsibility when the users understand the disclosure of key audit matter as the risk that auditor detected but not effectively addressed. Whilst, it decreases the perception of the auditor responsibility when the user understands it as the disclaimers of the responsibility. The key audit matter is considered as valuable information only if the auditor determines the right key audit matter, meaning that "the cause of loss should have been identified as a key audit matter" (KPMG, LLP, 2013). This means that identification of the right key audit matter should point to the unsatisfactory firm's performance.

1.1 Objective of study

In this study, we attempt to examine whether the financial performance indicators derived from the information reported in the financial statements provide evidence to support those key audit matters identified by the auditors. As disclosure of key audit matters is a new requirement imposed on auditor's report, this study will first identify the major types of key audit matters of most companies. Then a comparison will be made on certain financial ratios between companies suffering from specific key audit matters and those that do not. In addition, we also attempt to find out whether the disclosure of the key audit matter in the independent auditor's report is in line with the financial performance indicators based on ratio analysis. In other words, are the results of the financial ratio analysis consistent with the judgement of auditors in terms of key audit matters.

2. LITERATURE REVIEW

In the early twentieth century, accounting theory evolved into stewardship theory (Beaver, 1998). The theory assumes that there is no conflict of interest between the management (provider of the information) and the owner of the firm (investors). From the stewardship view, management has the responsibility to act in the interest of the investors. However, financial reporting can influence the management in various ways, it can affect the market value and the financing terms of the company (Beaver, 1998). Besides, the financial reporting information also has a link to the key performance indicators of the management. Thus, it is obvious that management has private incentives on the financial reporting (Beaver, 1998). This might cause the management to not act in the interest of the investors.

Since there are incentives of management in the financial reporting, here comes the role of auditor to monitor and provide assurance on the financial reporting (Beaver, 1998). Assurance service is to help improve the reliability and relevance of the information for the investors to be used as the basis for their decision-making (Arens et al., 2003). Assurance service is valued because the assurance service provider is independent and perceived as being unbiased with respect to the information examined (Arens et al., 2003). Besides, the value of the assurance service is appreciated by the public when the public understand and trust the work done by the auditor.

The financial statement audit is conducted to determine whether the financial statements are stated in accordance with ISA (Arens et al., 2003). Throughout the auditing process, enough and appropriate audit evidence will be gathered to form the opinion on the set of financial statements being audited. Auditors will issue an independent auditor's report to express their opinion about the audit of historical financial statements (Arens et al., 2003). Hence, the independent auditor's report is the communication tool between the auditor and the external users.

Recently, there is an increasing requirement on the disclosure in the auditor's report. ISA 700 (Revised) required the auditor to disclose the key audit matters in the independent auditor's report. Increased disclosures should bring down the level of information asymmetry (Leuz & Verrecchia, 2000). The requirement to disclose key audit matter as the additional information in the auditor's report turns the private information into public information, it reduces the information asymmetry between management and stockholders by communicating the risks and issues faced by the firms in the current period.

The purpose of the disclosure of key audit matters is to improve the communicative values of the independent auditor's report (Arnold & McGeachy, 2017). This makes the auditor's report to be more relevant to the users and help the users to understand the audit work done by auditor. Further, the key audit matters section of auditor report communicates on whether the disclosures provided by the management are biased from the real situation (Cordoş & Fülöp, 2015). The researchers believe that the key audit matter provide more information relevant to the users and enhance the usefulness of the auditor report. The new standard also intends to increase the transparency of audit performed by the external auditor to the users of financial statements (Arnold & McGeachy, 2017).

In the other way, the new disclosures may be uninformative if the practice does not serve it purpose. In the UK, the Financial Reporting Council passed a new standard that requires the auditors to disclose the risk of material misstatement. The new disclosure may be uninformative if it fails to reflect the real risk that faced by the company and if the risk that reported is already known by the investors (Lennox, Schmidt, & Thompson, 2018).

As defined in ISA 701, key audit matters are the matters that are significant in current period audit and selected from the matters that communicated with those charged with governance (Malaysian Institute of Accountants, 2015b). ISA 260 (Revised) requires the auditor to communicate with those charged with governance on a timely basis (Malaysian Institute of Accountants, 2018). Timely discussion with those charged with governance help to identify the key audit matters and attempt to robust the two-way communication about how the key audit matters were being addressed in the annual report (Arnold & McGeachy, 2017). The effective communication might be important to help those charged with governance to carry out their responsibility to oversee the preparation process of financial report and thus it minimizes the risk of material misstatement of financial statements (Malaysian Institute of Accountants, 2018).

There are studies regarding the post-implementation effects of audit reporting changes. The issues raised are the cost and benefit of the audit reporting changes and whether the increase in the public disclosure will increase in audit fee. Li, Hay, and Lau (2018) shows that the change of the audit reporting does increase the audit fee. It means that the adoption of the new audit reporting standard does improve the audit quality and achieved the intended benefit from the expanded disclosures in auditor report.

On the other hand, the financial statements, which serve as the major means for the management to discharge their accountability, provide relevance and faithful representative financial information for investors and creditors to evaluate the performance of the reporting entities. Hence, the financial information is used as major input for performance evaluation. It is therefore argued that companies that were identified for having certain key audit matters should reflect similar problems in their financial data through ratios analysis. As such, financial ratios will be used as financial performance indicators of the firm's performance in this study. Ratio analysis is the method that compute and interpret the financial ratios (Gitman & Zutter, 2015). The interpretation of the financial ratios used to analyse and monitor the firm's performance (Gitman & Zutter, 2015).

3. RESEARCH METHODOLOGY

3.1 Data source and sampling

This study collected data from the secondary source which is the independent auditor's report published in the annual reports of the public companies listed on Bursa Malaysia main market. Companies operate in the financing industry, closed-end fund and exchange traded funds are excluded in this study as they are subject to different disclosure requirements. The financial data are gathered from the Datastream database. Data for Year 2017 are used in this study since the ISA 700 (Revised) is effective on or after December 15, 2016. This is to be fair on the sampling because in Year 2016, for firms with financial year end earlier than December, they are not required to comply with the new standard. A total of one hundred firms are chosen by simple random sampling for the data analysis purpose.

3.2 Variable measurement

The key audit matter is disclosed in the independent auditor's report in accordance with the ISA 700 (Revised). To measure the key audit matters, a content analysis was conducted on the independent auditor's report. The issues were discussed and disclosed in a separate section under the heading of "Key Audit Matters" for most companies. The results of the content analysis reveal that the top three key audit matters disclosed in the independent auditor's report of the 100 firms are related to three main financial elements namely revenue, trade receivable and inventory. Based on this analysis, the firms thus, grouped into six different groups as shown in table 1 below:

Table 1. Classification of companies based on key audit matters

Group	Classification	Number of companies
1	Revenue recognition is not identified as key audit matter.	59
2	Revenue recognition is identified as key audit matter.	41
3	Trade receivable is not identified as key audit matter.	62
4	Trade receivable is identified as key audit matter.	38
5	Inventory is not identified as key audit matter.	64
6	Inventory is identified as key audit matter.	36

From the content analysis, it shows that the key audit matter of 41 companies was related to revenue recognition issues, whereas 38 companies related to trade receivable and 36 companies related to inventory respectively. In this study, firm's performance is measured by six financial ratios classified according to liquidity, activity, leverage, and profitability ratios. The financial data were obtained from the Datastream database.

Table 2. Formula to calculate the financial ratios

Financial Ratios	Formulas
Current ratio	Current assets / Current liabilities
Inventory turnover	Cost of goods sold / Inventory
Average collection period	Accounts receivable / Average sales per day
Total asset turnover	Sales / Total assets
Debt ratio	Total liabilities / Total assets
Operating profit margin	Operating profits / Sales

Other firm characteristics that will be tested in this study are the growth opportunities, firm size and the audit quality. The growth opportunities are the market value to the book value of the firm. The firm size is represented by the total assets. Finally, the audit quality is defined by whether the independent auditor is Big 4 accounting firm or not.

4. RESULTS AND DISCUSSION

Table 3 provides the results of the univariate tests of the differences, in mean values, of financial performance variables between Group 2 that was identified to have revenue recognition as key audit matter and Group 1 that was not. The independent samples t-test was performed between the two groups. This study observes that Group 2 (revenue recognition is identified as key audit matter), had a significantly at 0.05, higher operation profit margin than Group 1 (revenue recognition is not identified as key audit matter) by a mean difference of - 0.13%.

Operating profit margin is the financial performance indicator that calculate the operating profit generate from each sales dollar. The higher the operating profit margin the better the performance of the firm. However, from the table, Group 2 has higher mean of operating profit margin as compared to Group 1. This suggests firms that were identified as having revenue recognition issue performed better according to the financial ratio.

Table 3. Univariate tests between groups with revenue recognition issues and otherwise

	Group 1	Group 1	Group 2	Group 2	Difference Test
	Mean	**Standard Deviation**	**Mean**	**Standard Deviation**	**Mean**
Current ratio	2.896704	3.145177	2.598664	2.436551	.298037
Inventory turnover	13.31146	34.43656	96.65843	528.3341	-83.34696
Average collection period	140.7948	186.1371	194.9354	368.5034	-54.1406
Total asset turnover	.7884226	.6763391	.8882663	.6633683	-.0998437
Debt ratio	19.65055	17.92353	16.51731	13.98671	2.133249
Operating profit margin	-.0887983	.3618662	.0431387	.3184171	-.131937**
Other firm characteristics					
Growth opportunities	1.500678	3.066254	3.913415	11.84334	-2.412737*
Logged total assets	5.646621	.7479771	5.886038	.585222	-.239417**
Audit quality	.4067797	.4954498	.5121951	.5060608	-.1054155

Notes: The difference test is independent samples t-test for mean difference.
Group 1: Revenue recognition is not identified as key audit matter.
Group 2: Revenue recognition is identified as key audit matter.
* Significant at the 90% confidence interval
** Significant at the 95% confidence interval
*** Significant at the 99% confidence interval

A further analysis on the justifications provided by the auditors for their judgement indicates that the external auditor identified the revenue recognition as the key audit matter mainly because of the revenue involve high volume of transactions that may give rise to the material misstatement and due to construction contract accounting of revenue that require special audit consideration and involved significant management's judgements and estimates. This suggests that the revenue recognised for Group 1 may be inflated and hence resulted in better profit margin.

The result of the T-test shows that Group 1 and Group 2 do not have significant difference on the mean values for other financial performance indicators, i.e. current ratio, inventory turnover, average collection period, total asset turnover and debt ratio. In comparison of the firm characteristics, Group 2 (firms that were identified by the external auditors to have revenue recognition as key audit matter) were larger in size and have better growth opportunities than Group 1.

Table 4. Univariate tests between group with trade receivable as key audit matter and otherwise

	Group 3	Group 3	Group 4	Group 4	Difference Test
	Mean	**SD**	**Mean**	**SD**	**Mean**
Current ratio	3.007686	3.467983	2.394059	1.3838	.6136265
Inventory turnover	11.75386	21.22688	105.7798	549.3613	94.02594*
Average collection period	98.10216	82.61778	268.8661	416.1873	-170.7639***
Total asset turnover	.9253387	.7162572	.6727593	.5593703	.2525794**
Debt ratio	18.0108	16.81609	18.94534	15.96029	18.36592
Operating profit margin	-.0096097	.3169059	-.0756478	.3973785	.0660381
Other firm characteristics					
Growth opportunities	3.365806	10.02569	1.060789	1.041673	2.305017*
Logged total assets	5.87956	.6564446	5.524881	.7029924	.3546798***
Audit quality	.5806452	.4974818	.2368421	.4308515	.3438031***

Notes: The difference test is independent samples t-test for mean difference. SD denotes standard deviations.
Group 3: Trade receivable is not identified as key audit matter.
Group 4: Trade receivable is identified as key audit matter.
* Significant at the 90% confidence interval
** Significant at the 95% confidence interval
*** Significant at the 99% confidence interval

In Table 4, independent samples t-test was performed by comparing the mean of financial ratios for firms reported to have trade receivable as key audit matter and otherwise. In consistent with the expectation, Group 4, (trade receivable is identified as key audit matter) had a significantly, at 0.01, longer average collection period than Group 3 (trade receivable is not as key audit matter). The average collection period of the two groups is different by 170.8 days.

Average collection period is related to the firm's credit terms, the shorter the average collection period means that the firm is effective at collecting the trade receivable, whilst, the longer average collection period means that the firm is not enforcing the firm credit terms strictly. The long aging trade receivable should be written off. From the Table 4, Group 3 have shorter average collection period than Group 4. This suggests that Group 4 suffered from poor performance on average collection period as compared to Group 3. From the view of financial ratio, Group 4 is unsatisfactory as compared to Group 3, which indicates that the auditor judgement is supported by the financial ratio.

Group 4 had significantly at 0.05, 0.25 times lower total asset turnover than Group 3 based on the mean values. Total asset turnover is the financial performance indicator that measures the efficiency of the firm to utilize the firm assets to generate revenue. Higher total asset turnover indicates that the firm has higher ability to turn its assets into revenue. Table 4 indicated that Group 4 has the lower mean of total asset turnover than Group 3. Based on the financial ratio, Group 4 is unsatisfactory as compared to Group 3, which indicates that the auditor judgement is supported by the financial performance indicator. This proves that the key audit matter had pointed out the division of the firms that performed unsatisfactory. This information is useful for the users to make decisions. This is also aligned with the reasoning that key audit matter is a value information only if the auditor determines the right key audit matter, meaning that "the cause of loss should have been identified as a key audit matter" (KPMG, LLP, 2013).

As for inventory turnover, the difference between the two groups is only marginally significant, which is at 0.1. Group 3 had a lower inventory turnover as compared to Group 4. Inventory turnover is to measure the liquidity of the inventory or how many times the inventory is sold. Higher inventory turnover implies that the firm is faster to sell out the inventory, also lead to higher sales and higher trade receivable. High volume of transaction of trade receivable means the management need to make more significant judgements on yearly impairment review of trade receivable, the credit term of the firm and assessed the recoverability of the debts.

The further investigation reveals that the firms which were identified to have trade receivable as key audit matter were mainly because of the impairment and recoverability of trade receivable involves significant management judgement. The results depicted in Table 4 are consistent with the expectation, where the firms which identified to have trade receivable as key audit matter had higher inventory turnover. The firms that sell out inventory faster tend to have problem on making judgement about the trade receivable impairment and recoverability.

On the other hand, the result of the T-test shows that Group 3 and Group 4 do not have significant different on the mean of the four other financial performance indicators i.e. current ratio, debt ratio and operating profit margin. The firms that identified by the external auditors to have trade receivable as key audit matter in this study were smaller in size, have worsen growth opportunities and lower audit quality.

Table 5. Univariate tests between group with inventory identified as key audit matter and otherwise

	Group 5	Group 5	Group 6	Group 6	Difference Test
	Mean	**SD**	**Mean**	**SD**	**Mean**
Current ratio	2.781056	3.386831	2.762866	1.609855	.01819
Inventory turnover	71.70899	423.4667	4.416577	3.971772	67.29241
Average collection period	193.2549	334.3652	109.1926	93.50418	84.06225*
Total asset turnover	.7111506	.5691342	1.039506	.7834717	-.3283551***
Debt ratio	19.84272	17.40234	15.74051	14.37114	4.102209
Operating profit margin	-.0714774	.418757	.0306705	.1496354	-.1021479*
Other firm characteristics					
Growth opportunities	3.147969	9.907066	1.32	1.018077	1.827969
Logged total assets	5.855804	.7391315	5.547411	.5587258	.308393**
Audit quality	.515625	.5037065	.3333333	.4780914	.1822917**

Notes: The difference test is independent samples t-test for mean difference. SD denotes standard deviations.
Group 5: Inventory is not identified as key audit matter.
Group 6: Inventory is identified as key audit matter.
* Significant at the 90% confidence interval
** Significant at the 95% confidence interval
*** Significant at the 99% confidence interval

In Table 5, independent samples t-test was performed by comparing the mean financial ratio of firms reported to have inventory as key audit matter and otherwise. This study observes that Group 6, inventory is identified as key audit matter, had a statistically significant 1.04 times, higher total asset turnover than Group 5, trade receivable is not identified as key audit matter, 0.71 times, by a mean value difference of -0.33 times.

Relatively to the total asset turnover, Group 6 has higher mean than Group 5. Based on the financial ratio, Group 5 is unsatisfactory as compared to Group 6. The firms that suffered from inventory issue performed better than those firms that did not suffer from inventory issue, which indicates that the auditor judgement is not supported by the financial performance indicator.

From the independent auditor's report of Group 6, auditor identified inventory as key audit matter because inventory need the management to periodically reviews the inventories for potential write-downs by identifying slow moving or obsolete inventories as well as evaluating their net realisable value. These reviews involve significant judgements and estimation uncertainty in forming expectations about future sales and demands.

Besides, the inventory formed large and significant amount of the total assets. The auditor sent out the signal of the risk of material misstatement on the inventory but not reflected on the financial performance indicator.

In terms of the average collection period, Group 6 has a marginally significant, at 0.1, lower mean than Group 5. Based on the financial ratio, Group 6 performed better as compared to Group 5. This indicates that firms that suffered from inventory issues performed better on average collection period. The result is contradicted to the expected outcome. Besides, Group 6 has a higher mean of operating profit margin as compared to Group 5 which means the firms that suffered from inventory issue performed better as indicated by the financial ratio. This suggests that the auditor judgement is not supported by the financial performance indicator. Thus, further research is needed to find out the reason of the contradiction.

The result of the T-test shows that Group 5 and Group 6 do not have significant difference on the mean of the other financial performance indicators, i.e. current ratio, inventory turnover and debt ratio. The firms that identified by the external auditors to have inventory as key audit matter in this study were smaller in size and lower audit quality.

5. CONCLUSION

The findings of this study show that the disclosure of the key audit matter in the independent auditor's report is not always in line with the financial performance indicators based on ratio analysis. The findings can be categorised into two circumstances. Firstly, the key audit matter is in line with the financial performance indicators. This circumstance indicates the significant risks that faced by the firm in the current period which led to the poor performance of the firms. The firms identified trade receivable issue as key audit matter by auditor also has poor performance on average collection period and total asset turnover. This is where the auditor points out the reason of the poor performance of the firms.

Secondly, the key audit matter signals the areas need significant judgement from management which may give rise to material misstatement but does not reflected on financial performance indicators. The key audit matter in the second circumstance indicates the potential risk that faced by the firm, but it hasn't taken place in the firm. In the key audit matter section, the auditors also stated the method they used to assess those matters. The firms that suffered from revenue recognition and inventory issues are performing better as according to the financial ratio. The auditor gave the signal of the risk of material misstatement, but the firms are not certainly performing poorly. The findings of this research study provide evidences that the identified key audit matter supplies information to investment analysts to understand the issues faced by the firms.

Moreover, the results of this study show that the key audit matter section that practised in the industry is matched with the requirement in ISA 701 Communicating Key Audit Matters in the Independent Auditor's Report. The key audit matters that identified by the external auditors are the areas that significant risk identified as in first circumstance or have high risk of material misstatement and significant judgement needed as in second circumstance.

For future, it is suggested that this research could be conducted on a larger sample size and extended the study on how the investors interpret and react on the key audit matter. In addition, future research could also examine whether the communication of key audit matter minimize the expectation gap.

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