The Impact Generated by the Key Audit Matters on the Application of Audit Procedures

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Abstract

The international standards related to the structure of the audit report over the years have undergone significant structural changes, especially with ISA 701 (in Brazil NBC TA 701), where the audit report started to document a discretionary section called Key Audit Matters (KAM), whose objective is to disclose issues or critical points identified by the auditors, who admittedly considered important for a better understanding of the financial statements by external users, in addition to understanding the procedures performed by the auditors themselves. Through documentary analysis of 16 audit reports related to 8 financial statements without KAM (2015) and 8 financial statements with KAM (2016), as well as the respective working papers, letters of external circulation and workbooks prepared by the audit teams, obtained together with a certain relevant external audit company in the Brazilian domestic market, information was tabulated regarding the audit procedures applied, where the objective was to verify whether the need to disclose the paragraph of KAM made the auditors more skeptical in performing the audit work. By the comparative method, as well as by the application of the t-Test: two samples in pair for averages was identified strong and positive correlation between the variables tested. Thus, the results obtained suggest that the disclosure of the KAM paragraph caused an increase in the procedures performed when comparing the reports between 2015 and 2016.

**Keywords:** Audit report; Key audit matter; Skepticism

1. Introduction

The external audit over the years has been playing and gaining a very important highlight in the economic scenario, as well as in organizational development, in providing information to internal and external users, and currently in Brazil in the governmental aspect.
The main product generated by the independent auditors is the audit report. Over time, some modifications have emerged with the main objective of making the audit report more descriptive and informative. Under the current model, in addition to the presentation of reservations, the main inconsistencies identified by auditors during the execution of audit procedures should be formalized in the report so that all users are aware of the accounting, economic and financial situation of the organization.

According to Matos (2017) since the financial crisis of 2007/2008, new regulatory debates on the audit report have been gaining prominence in international bodies such as the International Auditing and Assurance Standards Board (IAASB), Public Company Accounting Oversight Board (PCAOB), and the Financial Reporting Council (FRC).

Since then the audit report has undergone some structural changes. No longer is it presented on an individualized basis, containing general information regarding the responsibilities of management and auditors, or the opinion of auditors. The main objective of the aforementioned regulatory bodies is to make audit reports more informative, where there would be more transparency about the work of the auditor, its responsibilities and also the responsibilities of management, as well as to make it more personalized in accordance with the specificity of each client's business model.

In this regard, the IAASB issued the International Standard on Auditing (ISA) 701, where the auditors' report will now have a discretionary section called Key Audit Matters (KAM), also called by the PCAOB Critical Audit Matters (CAM), and in Brazil by the Federal Accounting Council (CFC), according to NBC TA 701, Principal Audit Matters (PPA). This new part of the audit report, which will be the object of study in this dissertation, will be adopted as terminology the acronym KAM.

In this section, the auditors must disclose critical issues or points identified during the fieldwork, which are known to be important for the understanding of the financial statements by external users, in addition to the understanding of the procedures performed by the auditors themselves.

The change resulted from external demand from external users of the statements who would like the auditor's report to provide more than one approval or disapproval opinion (KPMG, 2017).

Even after the need to disclose the KAM paragraph, the work methodology of the independent auditors has not changed. The standard enabled auditors to communicate with the users of the financial statements, in a more transparent way, their work and their responsibilities as well as the responsibilities of the governance of the organization (IFAC, 2011).

In view of the above, where the change in the structure of the audit report was presented, the following problem arises: the need to disclose the Key Audit Matters (KAM) paragraph increased the professional skepticism of the independent auditors in terms of the application of audit procedures?

The purpose of this study is to evaluate how the disclosure of the KAM paragraph impacted the planning, calculation of materiality, execution and formalization of audit procedures, as well as the identification of control points and accounting adjustments.

The work was carried out structurally as follows: the second chapter describes the foundation of the work structurally as follows: the second chapter describes the theoretical foundation; the third chapter presents the methodology; the fourth chapter details the analysis of the result; the fifth chapter presents additional analyses; finally, the sixth chapter presents the theoretical final considerations; the third presents the methodology; the fourth chapter details the analysis of the result; the fifth chapter presents additional analyses; finally, the sixth chapter presents the final considerations.

2. Previous Research

Below are some studies that strengthen the auditor's professional skeptical behavior. As a reference, three studies will serve as a backdrop for the theme of professional skepticism, these will be presented in order to highlight the research, methods and conclusions related to the subject.
Brewster, Peecher and Solomon (2015) developed and reported hypothetical experimental tests that predicted improved auditor assessments of the risk of intentional material distortion in two ways, i.e., making these assessments more evidence-based and less heuristic. The experiment was attended by 87 professional auditors from a Big Four training session, with an average professional experience of 44.52 months. According to the authors, auditors with this length of experience substantially review non-recurring journal entries such as the case material. To verify, the auditors reported the number of accounting records they had checked, providing an average of 10.07 records. For the authors, this suggests that the participants had the specific experience and knowledge of the task.

In the experimental task, the auditors evaluated a periodic non-recurring entry, increased income and the administration's intentions to make this entry. In Part I, the participants read the skepticism orientation. They then read about a fictitious supplier of car parts. The case provides financial information, describes a previous favorable relationship with management, and includes a hypothetical interview of Forbes magazine by the company's CFO, describing a strong commitment to the quality of the financial report. The CFO says it does not approve of profit management that distorts economic reality.

Participants evaluate a non-recurring journal entry record approved by the CFO, which reduces the expense and liability of the guarantee. Gains fall below analysts' predictions before entry, but only expire later. This information signals an increasing risk of intentional and material distortion. Auditors should be skeptical in the planning and execution of procedures. Management states that journal entry faithfully reflects manufacturing improvements and decreases future returns. The manipulation of evidence corroboration is described in the evaluation of another member of the audit team. After receiving this assessment, participants measure the risk of intentional distortion of material. The primary task of the experiment is to evaluate management's intentions for a periodic, non-recurring input that allows gains to only meet analysts' forecasts.

The authors suggested that in assessing the risk of intentional material misstatement, relatively newer auditors will have greater difficulty than relatively more experienced auditors in meeting the requirements of sceptical professional standards in making proper evidence-based risk assessments.

Nolder and Kadous (2015), in their study, performed the conceptualization of the attitude and the taxonomy of understanding the original situations of audit deficiencies. For the authors, professional skepticism is fundamental for quality audit, and a failure in the application of professional skepticism is often identified as a root cause of audit deficiencies. In the article, they first developed a definition of professional skepticism, along with measures that can be used to infer the nature and strength of the underlying attitudes of the auditor's professional. The measures included skeptical judgments and actions, as well as an affective aspect, which is gaining attention in audit research. They then used literature arguments examining the impacts of the attitude/behavior relationship to better understand when attitudes are likely to be a root cause of behavior and when they are not. The authors' findings are summarized in a taxonomy of the attitude/behavior relationship for professional skepticism. Finally, they offered suggestions based on analysis to improve future studies of professional skepticism.

Considering the conclusions established in the researches mentioned in this study, as well as the theoretical basis on professional skepticism, a hypothesis is developed that will be studied.

3. Hypothesis
By proposing the new format of the report, the regulatory bodies of the audit standards aimed to improve the transparency of information, in order to provide input on how auditors dealt with critical issues, as well as to facilitate the understanding of the information disclosed to external users. Thus, generating greater confidence for the investor market, thus the research hypothesis is:

**H1:** The obligation to disclose KAM impacted the planning of auditors in order to generate greater effort in terms of execution of audit procedures.
4. Research Method

This chapter describes the methodological procedures that will enable the problem situation, already presented in chapter 1, to be answered. Thus, the chapter is divided into four parts: the first consists of data collection, the second in the description of the sample, the third in the treatment of data, and the last one details the profile of the companies.

4.1. Data

The database consists of working papers, letters of external circulation, work folders, related to audits of financial statements of 2015 (without KAM) and 2016 (with KAM) obtained together with a certain relevant external audit company in the Brazilian domestic market, which has extensive experience in the segment of operation, whether providing services to national or international clients.

In order to test the hypothesis proposed in the study, the documentary analysis was conducted based on the information contained in the external circularization letters, workbooks, and the work papers of the external auditors, in accordance with the disclosure of the KAM paragraph in the audit report.

4.2. Description of the Sample

The sample consists of 16 audit reports related to 8 financial statements without KAM and 8 financial statements with KAM, as well as the respective work papers, letters of external circulation and work folders prepared by the audit teams, whose audit documents make up the information base.

All the companies analyzed were audited by this audit firm in the two years analyzed, that is, in the years ended 2015 (without KAM) and 2016 (with KAM).

The information analyzed was: calculation of materiality, procedures performed, audit team and formalization of audit procedures.

Regarding the calculation of materiality, the objective was to identify whether there was a change in the benchmark adopted in the evaluation of the audit team before and after the need to disclose the KAM paragraph. Additionally, it was also verified the percentage limits used in the calculation of materiality, in order to assess whether there was a large difference in the values plotted for calculation metrics.

On the other hand, the analysis related to the procedures performed, aimed to describe all the procedures applied by the audit teams, according to the planning. The objective was to verify whether the disclosure of the KAM paragraph increased the auditor's professional skepticism, specifically reflected in the number of procedures planned and executed. The standard procedures evaluated in the auditors' work papers according to the accounting nature were: available, financial investment, accounts receivable, other accounts receivable, inventory, long-term receivables, investment, fixed assets, intangible, loans and financing, suppliers, accounts payable, other accounts payable, long-term liabilities, shareholders' equity, results, subsequent events and contingencies.

Finally, the last items: the audit team and the formalization of audit procedures verified whether the same team participated in the audit work before and after the release of the paragraph of KAM, thus, the main objective was to verify whether with the new standard there were incremental changes in the amount of audit procedures performed, in addition to the verification whether the critical formalization of the procedures previously planned was more accurate and skeptical.

4.3. Data Processing

The treatment of the documents involved the comparative analysis of the information, in addition to the use of the Statistical Package for Social Science (SPSS) software version 16.0, applying the Paired-Samples T Test (Test-t). In each item analyzed at the end, it was documented whether or not there was significant change in the formalization, documentation and skepticism of the auditor according to the disclosure of the KAM paragraph.
The comparative method was adopted in the research, since the information obtained according to the analysis of the working papers, letters of external circulation, workbooks of the auditors comparing the information before and after the need to disclose the paragraph of KAM.

On the other hand, the statistical model used allows inferring on the equality of means of two paired samples, i.e., each situation is analyzed at two moments. The first before and the second after an intervention, thus forming pairs of observations whose differences are tested in order to verify whether or not the result is zero (SILVA, 2014).

Application of the test consisted in evaluating the average number of procedures applied before and after the need to disclose the KAM paragraph.

### 4.4. Profile of the Companies Analysed

Table 1 describes the main characteristics of the companies analysed.

<table>
<thead>
<tr>
<th>Company</th>
<th>Segment of action</th>
<th>Company Type</th>
<th>Year of commencement of the audit service contract</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>Heavy construction S.A.</td>
<td>2015</td>
<td></td>
</tr>
<tr>
<td>B</td>
<td>Execution of industrial engineering projects in general and in civil construction S.A.</td>
<td>2015</td>
<td></td>
</tr>
<tr>
<td>C</td>
<td>Participation, as parent company or not, in the capital of commercial, industrial or service companies S.A.</td>
<td>2015</td>
<td></td>
</tr>
<tr>
<td>D</td>
<td>Medical assistance Ltda.</td>
<td>2016</td>
<td></td>
</tr>
<tr>
<td>E</td>
<td>Heavy equipment manufacturing S.A.</td>
<td>2012</td>
<td></td>
</tr>
<tr>
<td>F</td>
<td>Activities the execution of earth moving, paving, sanitation, irrigation, civil construction, railway and port works, dredging services and other engineering activities S.A.</td>
<td>2014</td>
<td></td>
</tr>
<tr>
<td>G</td>
<td>Participation in other national or foreign companies, as a partner, shareholder or quotaholder, and formation of consortiums, including those aimed at the exploitation of medical services of any nature S.A.</td>
<td>2016</td>
<td></td>
</tr>
<tr>
<td>H</td>
<td>Provision of medical, hospital and outpatient services Ltda.</td>
<td>2016</td>
<td></td>
</tr>
</tbody>
</table>

Table 1 shows that the companies used for comparative analysis are from various business segments, in addition to being considered medium to large, in accordance with their respective financial statements. It is also noteworthy that they are constantly audited, in addition to being audited in recent years by the audit firm that provided all the resources used in the study, which makes the analyses more feasible with the hypotheses suggested for study.

### 5. The Results of Hypotheses Testing

In this part of the study, according to the proposed design, the analysis of the results will allow testing the hypothesis, as described below: the obligation to disclose KAM impacted the planning of auditors in order to generate greater effort in terms of execution of audit procedures (H1).

#### 5.1. Effect of KAM on the Implementation and Formalisation of Audit Procedures

The hypothesis H1 - the obligation to disclose KAM impacted the planning of auditors in order to generate greater effort in terms of execution of audit procedures - maintains that because of the obligation to disclose KAM, the audit teams modified their respective work plans, therefore, tended to a greater effort in terms of average increase of procedures performed.

In this aspect two points are highlighted: the first refers to the quantitative bias, the procedures outlined in the planning are superior in the quantity of tests planned and executed if compared to when
there was no KAM, while the second point is analyzed from the qualitative point of view, thus, the formalization of the procedures by the auditors would require greater critical attention and better description of everything that was verified throughout the application of the audit tests. According to the comparative analysis of the sample under study, the following table is presented:

**Table 2:** Number of procedures and level of formalization of the procedures performed before and after disclosure of the KAM paragraph

<table>
<thead>
<tr>
<th>Company</th>
<th>Number of procedures before KAM disclosure</th>
<th>Number of audit procedures after KAM disclosure</th>
<th>(+) Addition/(-) Reduction</th>
<th>Formalisation of the audit procedures carried out</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>59</td>
<td>62</td>
<td>+ 3</td>
<td>Better formalization after disclosure of the KAM paragraph, according to the analysis of the working papers</td>
</tr>
<tr>
<td>B</td>
<td>69</td>
<td>76</td>
<td>+ 7</td>
<td>Better formalization after disclosure of the KAM paragraph, according to the analysis of the working papers</td>
</tr>
<tr>
<td>C</td>
<td>35</td>
<td>46</td>
<td>+ 11</td>
<td>Better formalization after disclosure of the KAM paragraph, according to the analysis of the working papers</td>
</tr>
<tr>
<td>D</td>
<td>76</td>
<td>94</td>
<td>+ 18</td>
<td>Same level of formalization for before and after disclosure of the KAM paragraph, according to the analysis of the working papers</td>
</tr>
<tr>
<td>E</td>
<td>50</td>
<td>51</td>
<td>+ 1</td>
<td>Same level of formalization for before and after disclosure of the KAM paragraph, according to the analysis of the working papers</td>
</tr>
<tr>
<td>F</td>
<td>49</td>
<td>61</td>
<td>+ 12</td>
<td>Better formalization after disclosure of the KAM paragraph, according to the analysis of the working papers</td>
</tr>
<tr>
<td>G</td>
<td>31</td>
<td>44</td>
<td>+ 13</td>
<td>Better formalization after disclosure of the KAM paragraph, according to the analysis of the working papers</td>
</tr>
<tr>
<td>H</td>
<td>38</td>
<td>53</td>
<td>+ 15</td>
<td>Better formalization after disclosure of the KAM paragraph, according to the analysis of the working papers</td>
</tr>
<tr>
<td>Totals</td>
<td>407</td>
<td>487</td>
<td>+ 80</td>
<td></td>
</tr>
</tbody>
</table>

According to the table above, it can be seen that in absolute terms for all audit work performed in the respective companies there was an addition of 80 new audit procedures compared to the tests performed before the need to disclose the KAM paragraph, which represents a greater effort of 20% by the teams involved in the application of the audit procedures, with a respective average of 51 and 61 procedures performed before and after the KAM paragraph.

With the above information, it is possible to verify that at no time was the number of procedures executed before the need to disclose the KAM paragraph exceeded the number of procedures executed after the need to disclose the KAM paragraph, which empirically suggests that the adoption of KAM made the auditor more conversant in the planning and execution of procedures.

Analyzing the number of procedures performed by the audit teams before and after the need to disclose the KAM paragraph, by applying the t-Test, considering the alpha significance level equal to 5%, the following results were generated::
Table 3: H1 results in terms of average number of procedures performed by auditors:

<table>
<thead>
<tr>
<th>Paired Samples Statistics</th>
<th>Mean</th>
<th>N</th>
<th>Std. Deviation</th>
<th>Std. Error Mean</th>
</tr>
</thead>
<tbody>
<tr>
<td>Procedures performed without KAM</td>
<td>50.8750</td>
<td>8</td>
<td>16,2253</td>
<td>5,73659</td>
</tr>
<tr>
<td>Procedures performed with KAM</td>
<td>60.8750</td>
<td>8</td>
<td>1687295</td>
<td>5,96549</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Paired Samples Correlations</th>
<th>N</th>
<th>Correlation</th>
<th>Sig</th>
</tr>
</thead>
<tbody>
<tr>
<td>Procedures performed without KAM &amp; Procedures performed with KAM</td>
<td>8</td>
<td>0.938</td>
<td>0.001</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Paired Samples Test</th>
<th>Paired Differences</th>
<th>Mean</th>
<th>Std. Deviation</th>
<th>Std. Error Mean</th>
</tr>
</thead>
<tbody>
<tr>
<td>Procedures performed without KAM - Procedures performed with KAM</td>
<td>-10.0000</td>
<td>5.87975</td>
<td>2.07880</td>
<td>-4.810</td>
</tr>
</tbody>
</table>

Table 3 shows a very strong and positive correlation of 0.938 between the obligation to disclose the KAM paragraph and the average increase in audit procedures performed, which is exactly corroborated by the difference between the averages of 10 procedures.

Still analyzing the results above, considering that the p-value calculated (0.002) is lower than the alpha (0.05), it can be concluded that statistically there is a significant difference between the averages, therefore, the increase in the average referring to the number of procedures performed by auditors is associated with the need to disclose the KAM paragraph.

The conclusion is corroborated by the use of the statistical model T-test, which tested the average of the procedures performed before and after the disclosure of KAM, thus identifying a significant relationship between the variables. Another highlight of the study is documented in table 2, where it was comparatively identified that in terms of formalization of the working papers there was significant improvement, which empirically strengthens that the need to disclose the paragraph of KAM made the auditor even more zealous and careful in approaching the audit procedures.

Summary and Concluding Remarks
The work carried out by independent auditors has always been recognized as autonomous from the interests of the governance of organizations, since the results generated by the application of audit procedures are substantially complete, accurate and without room for ambiguous or confusing interpretations. However, the IAASB, through the adoption of new standards linked to the audit report, proposed greater transparency in the disclosure of the audit report with the adoption of ISA 701, in Brazil NBCTA 701. This standard has changed the structure of the report, now the auditor reports the Key Audit Matters, or in Portuguese, the main audit matters.

According to Matos (2017, p.40): "the standard [...] gives the auditor the discretion on how to report critical audit matters in his report, enabling the inclusion or not of information that may be relevant to the user of the accounting information".

The hypothesis test analyzed the possible effects that the disclosure of the KAM paragraph had on the design and execution of audit procedures, given the auditors' scepticism.

The point of study was clearly to investigate whether the need to disclose the KAM paragraph has categorically changed the number of procedures performed in the audit.

The results of the study obtained through a comparative analysis of 16 audit reports on 8 financial statements without the KAM paragraph (2015) and 8 financial statements with the KAM
paragraph (2016), as well as the respective working papers, external circularization letters and workbooks prepared by the audit teams, indicate that the independent auditors, after disclosure of the KAM paragraph, fundamentally planned and performed more audit procedures during the fieldwork on the audited financial accounts.

In addition, it was also found that the auditor became more sceptical and judicious in his respective evaluations of the formalization of the procedures, through the mandatory disclosure of the KAM paragraph.

Empirically, through an absolute analysis of the information obtained, it was reported that the need to disclose the KAM paragraph led auditors to apply more audit procedures.

By applying the t-test, by analyzing the results, it was possible to verify a significant relationship between the increase in the average number of procedures performed by auditors and the need to disclose the KAM paragraph, thus validating H1.

In the supplementary analysis of the study, it was found that for the entire sample, the technical part responsible for planning the work remained unchanged, which strengthens the fact that with the release of the KAM paragraph, the auditors sought to further mitigate the audit risks in the execution and formalization of the procedures.

The study presents certain limitations in relation to the uniformity of the results allusive to the proposed theme, due to the use of intentional sample, since culturally the chosen niche is not motivated to answer academic researches, however, they express very important trends in the behavioral aspect intrinsic to the judgment of independent auditors.

The main contribution of the study was to analyze and describe the extent to which the professional skepticism of the independent auditors has changed with the change in the audit report, where it is necessary to describe and disclose the KAM paragraph. In addition, the published KAM studies have always focused on three lines of research: the first on markets that have already applied it, the second on auditors' liability and litigation risk, and the third on the potential impact on investors.

The empirical evaluation of the hypothesis described in the study, in view of the analysis of the auditors' work papers before and after the need to disclose the KAM paragraph, as well as the results generated by the Test-t, corroborate for the conclusion of the study where the auditors increased the average number of procedures performed, thus tending to be substantially more cautious in the execution of the audit work, which clearly reflected in the formalization of these procedures.

References


