The implementation of ISA 701 - Key Audit Matters: Empirical evidence on auditors’ adjustments in the new audit report

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Abstract

The previous audit report received significant criticism because it contained too much standard text that failed to convey valuable information to its users. This led to the implementation by the IAASB of a new standard called ISA 701-KAM, which was implemented by all listed companies at the end of 2016. The purpose of KAM is to make the audit report less standardized, and to instead provide transparent and entity-specific information. However, some believe that the confidentiality duty, which is a prerequisite to be able to perform an audit, can contradict the new standard. In order to investigate this issue, we interview auditors to obtain their view of how they have implemented and applied KAM in the audit report. The results reveal that auditors are skeptical about the audit report being as entity-specific and transparent as expected by the IAASB, since there is an underlying fear of overstepping TCD.

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List of acronyms

FAR – Swedish Institute of Authorized Public Accountants
FRC – Financial Reporting Council
IAASB – International Auditing and Assurance Standard Boards
IFAC – International Federation of Accountants
ISA – International Standards on Auditing
KAM – Key Audit Matters
TCD – The confidentiality duty
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Introduction

This chapter starts with a brief description of why key audit matters (KAM) has been implemented and continues with the problem discussion, which raises the difficulties of implementing KAM. The purpose of the study and research question is then presented. The chapter ends with the study’s contribution.

Background

The audit report is an important document for society, since it contains information that in many cases is used when users value and decide to invest in a company (Carrington, 2014). The audit report is also the essence of the communication between auditors and users, and in most cases is the only contact users have with the auditor (Libby, 1979). The audit report should convey whether the information presented in the financial statement prepared by the company is in accordance with the company’s actual financial position; this is examined through the auditor’s review of the audit process and is presented in the audit report (PwC, 2017).

The results of the audit review have previously been presented through a standardized design, whereby the auditor provides a brief description of the areas that have been audited, and indicates whether the audit report is unqualified (financial statements are fairly and appropriately presented) or qualified (financial statements are not fairly and appropriately presented) (Carrington, 2014). However, the standardized design received substantial criticism since it lacked information about the audit scope (Brännström, 2012; Carrington, 2014; Power, 1997). Furthermore, criticism was directed towards the standardized audit report not being informative enough, since the standard text in the audit report did not convey sufficient information about how it had been conducted (Asare & Wright, 2012 and Humphrey et al., 2009). As a result, users could not understand how auditors had come to their conclusions in regards to an unqualified or qualified audit report. Users thus demanded a more informative audit report that gives more insight into the company through entity-specific information and further descriptions of the audit scope (Brännström, 2012). According to Hjelström (2015) and Brännström (2012) all standardized audit reports look the same, which reduces users’ interest in reading them and leads to a risk of important information that users should know about being overlooked.

Due to this criticism of the standardized audit report, the International Auditing and Assurance Standards Board (IAASB) decided to publish a new standard in January 2015, called ISA 701 – Communicating Key Audit Matters (KAM), which was implemented at the end of 2016 by all listed
companies in Sweden. Through KAM, auditors can highlight those matters that by their professional judgment are of greatest significance in the audit, in addition to further descriptions about the audit scope to provide an understanding of the auditor’s responsibilities (EY, 2016). According to the IAASB, KAM should make the audit report less standardized and instead provide transparent and entity-specific information that is tailored to each company (IAASB, 2015). The IAASB (2015) also explain that the new audit report with extended audit statements should make the audit report clearer, since information is disclosed about the company’s main issues, and the scope of the audit is clarified. These proposed changes should significantly improve auditor reporting, and in turn reduce gaps in information and expectations. This follows the clearer description of auditors’ responsibilities, and the provision of information that has been demanded from the public.

**Problem discussion**

The research and literature about KAM differs, since researcher opinion surrounding the standard varies. Some researchers are supportive of the new standard and state that KAM can contribute to more transparent and entity-specific audit reports, while others believe that the significance of the audit report could be reduced. This is because the information can be overwhelming for users, since an overload of information can be difficult to interpret, and can in turn reduce users’ ability to identify important information (Chen et al. 2013). Cong & Pflugrath (2008) produced a study demonstrating that extended text in audit reports contributes to further dissimilarities among users and auditors. The authors argue that most of the problems between users and auditors arise as a result of users’ lack of understanding of data in the audit report. However, more information in the audit report makes the report more individualized, since auditors form an opinion about the company’s main issues in KAM. This is confirmed by the “big four” firms, who believe that the audit report should become more informative and have a more visible value as it becomes more entity-specific (IAASB, 2013).

However, Sirois et al. (2016) believe that the new standard will have no effect on whether the audit reports become entity-specific. Lennartson (2015) agrees on this matter, and emphasizes that the new standard will not make the audit reports less standardized because the entity-specific information only reflects a fraction of the information in the audit report. In contrast, Öhman (2007) argues that including more information in the audit report would be to users’ advantage, since audit reports would be easier to understand and more transparent. However, this could also lead to higher risk for auditors, since clients reveal sensitive information to which auditors have access.
This is confirmed by Humphrey et al. (2009), who state that an expanded audit report could stand in opposition to the confidentiality duty (TCD). This is because it is not permitted for auditors to state an opinion that could hurt the company, which could lead to auditors feeling less secure with the responsibility of writing an audit report containing further remarks on the company’s financial statements. TCD is essential for auditors to gain their clients’ trust and an open insight into their financial information (FAR, 2013). EY (2013) state that managers can have doubts about KAM, since it discloses specific information and the management might take issue with such information being released. FAR (2013) also comments on this issue and recommends that auditors should not form an opinion classified as KAM, but rather should describe the issue found in the audit without exposing too much information (FAR, 2013). Guénin-Paracini (2014) states that it is important to reflect on how the new standard will affect auditors in their daily work, since TCD can hinder auditors in writing an audit report containing extended audit statements.

**Purpose and research question**

The purpose of this study is to create an understanding of how auditors have interpreted and applied KAM in the new audit report. This is done by addressing factors that might affect how they design an audit report in accordance with IAASB requirements.

The research question of this paper is:

*How has key audit matters been interpreted and applied by auditors in the new audit report?*

**Contribution**

This study develops new insight into some practical difficulties faced by auditors, which should be taken into consideration when drawing conclusions about the effects of KAM in the new audit report. This study contributes to an understanding of how auditors have interpreted and applied KAM in practice. It is important to note that KAM is a regulation which relies on auditors’ professional judgments; consequently, the regulation has a decision-making framework. This means that auditors’ interpretations and knowledge are of great importance when formulating KAM in the audit report. Accordingly, auditors’ hidden knowledge is brought to light in this study by highlighting their thoughts and reflections on the difficulties brought about by the implementation of KAM when producing an audit report with extended audit statements. Since we examine how the new standard has been applied and interpreted by auditors in practice, this study also contributes to new knowledge that has yet not been disclosed in previous research. This is because the study was conducted at the same time as the
first audit report was produced and published in accordance with KAM.

Furthermore, this study demonstrates that the risk of overstepping TCD has prevented auditors from disclosing KAM to the same degree as the regulators had hoped for. In this regard, the study also highlights some limitations that prevent the information gap from being reduced, since auditors cannot be as informative as they might wish because of the risk of infringing TCD. However, our results indicate that KAM can assist in reducing the expectation gap, since auditors have more clarity about their responsibilities in the audit. Last but not least, this study also contributes to a deeper insight into how entity-specific the audit report has become.
Literature review

This chapter starts with a brief description about the principal–agent theory, which describes the information asymmetry between the principal and the agent, in order to highlight the importance of the role of auditors in companies. The chapter continues with a presentation of the previous and the current audit report. Information then follows about KAM, the expectation gap, the information gap, KAM’s impact on the audit report, auditors’ attitudes towards an expanded audit report, and TCD. The chapter concludes with a summary of the literature review and an analysis model that describes the connection of the different concepts discussed.

Principal–agent theory

The principal–agent theory describes the relationship between two parties within a company. The relationship is defined as a contract under which one person (the principal) engages with another (the agent) to perform services on the behalf of the principal, in order to affect the return of the company (Jensen and Meckling, 1976; Eisenhardt, 1989). According to Wallace (1980), a principal–agent relationship can occur between a variety of stakeholders, including between different levels of management, creditors, government and employers. However, Jensen and Meckling (1976) state that the principal–agent relationship mainly exists between owners and managers.

Company owners are not present in the company’s daily work as the management is, and therefore the management has the advantage of information over the owners. In other words, there is a distance between management and owners that creates information asymmetry. This indicates the possibility that managers could benefit themselves instead of the company, which can create an agency problem (Watts and Zimmerman 1979). The agency problem transpires when the agent takes advantage of possessing more information and focuses on reaching their own goals by using the principal’s resources (Jensen and Meckling, 1976). In order to reduce this conflict a third party, i.e. the auditor, is hired to work as a monitoring function to examine whether the principal’s goals are considered in every situation (Carrington, 2014; Watts and Zimmerman, 1979). This is accomplished by auditors reviewing the company’s financial statements, which are then presented in the audit report (Carrington, 2014).

In the agency problem, the auditor thus becomes information multipliers through the audit to reduce information asymmetry between the agent, the principal and the investors. With the help of the audit, the auditor is able to deliver information to these parties through the audit report, and so immediately
attacks the information asymmetry. In the case where auditors enter the company as a third party and review the company’s financial position, the investors and owner of the company also have the opportunity to make decisions based on the presented accounts. Since the auditor focuses on communicating information to the owners and stakeholders, their role can be described as an assurance to reduce information asymmetry between the owners, management and stakeholders (Moore & Ronen, 1990). According to Wallace (1980), the value of the audit is also its enhancement of the financial information that companies choose to convey to its owners and the outside world. Furthermore, the author also describes that when the auditor reviews the company’s financial reports, this pressures the company to deliver accurate information on the financial statements, since when the auditor reviews this information any errors in the statements can be detected. Financial statements are prepared by the company during the year and enable stakeholders to understand the economic situation of the company. By reviewing these statements, arguably auditors are certifying that the companies’ published accounts are correct in order for stakeholders to make useful investment decisions. The financial statement conveys information to stakeholders and facilitates creditors, customers, suppliers and shareholders when they valuate the company (Carrington, 2014). In turn, this leads to the quality enhancement and to increased performance from the company’s management. Furthermore, the audit also results in investors making rational investment decisions based on the figures presented by companies in their financial statements (Wallace, 1980).

This study focuses on the agent theory, since neither auditors nor the audit profession would exist if there was no agency problem. As mentioned above, the audit aims to provide owners and stakeholders with a rational view of an entity’s financial position by reviewing their presented financial information and describing it in the audit report.

**The audit report**

In the audit report, the auditor makes a statement about the company’s financial position over a certain period of time. First an audit review is carried out, in which the auditor examines the company’s income and balance sheet, its proposal for disposition of profit in the management report, and whether the management and CEO should be granted discharge for the financial year. The auditor should also inform the owners of any information that they should know about under the “other information” section in the report. In addition, statements should be provided on whether the financial accounts have been prepared in accordance with the Annual Accounts Act. If the financial report is prepared in accordance with regulatory law, the auditor signs the audit report (Carrington, 2014). In other words,
auditors apply a quality stamp on whether the financial position announced in the financial statements gives a true and fair view of the company (FAR, 2013).

The focus of the new audit report will be of the same nature as that of the previous report. Accordingly, auditors keep the main focus on reviewing the annual report and management report. However, there is a new section in the audit report called KAM, which aims to give auditors a platform to clearly communicate any significant risks and areas of focus, and how they were managed in the audit. The formalities of the new audit report have also changed, since auditors now write extended statements about the auditor’s and the management’s responsibilities. Furthermore, the auditor’s conclusion is given at the beginning of the audit report instead of the end (Lennartsson, 2015). The new audit report also provides enhanced reporting on any matters related to ongoing concerns (Lennartsson, 2014).

**Communicating KAM**

In the end of 2016, ISA 701-KAM was implemented for all listed companies in Sweden by the IAASB. The new standard was put in place because users requested a more informative audit report. The definition of KAM is as follows:

> “Those matters that, in the auditor’s professional judgment, were of most significance in the audit of the financial statements of the current period. Communicating key audit matters may also assist users of the financial statements in understanding the entity and areas of significant management judgment in the audited financial statements, as such matters are areas of focus in performing the audit” (IFAC, 2016 p. 2).

These new changes in the audit report enable auditors to enhance transparency in terms of the areas that require significant auditor attention, the company’s potential risks, and how these risks were managed. Accordingly, entries considered as time consuming and complex during the audit review are defined as KAM in the audit report (IFAC, 2016).

Paragraph 8 of ISA 701 states that KAM is chosen from issues that are communicated by those responsible to the management. These issues are thereafter discussed with the management and evaluated by the auditor, whereby those that require most of the auditors’ attention during the audit are defined as KAM in the audit report. Furthermore, ISA requires auditors to take three different factors into account when KAM is selected: those areas that are considered to be a target of material misstatement or that are considered to be significant risks, to understand the entity and its environment in order to identify and assess the risks of material misstatement, and significant auditor judgments in
relation to areas of the financial statements that involve significant management judgment. This might include accounting estimates that have been identified by the auditor as having a high degree of estimation uncertainty, and the effects on the audit of significant events or transactions that have taken place during the audit period (IFAC, 2016).

Consequently, the auditor must decide which areas in the audit were of most significance during audit of the financial statements, and must thereafter define these as KAM in the audit report (ibid). When the auditor has selected the issues to be defined as KAM in the audit report, it is of great importance that they ensure each KAM is described in an appropriate way. This description must include: “why the matter was determined to be one of most significance and therefore a key audit matter, and how the matter was addressed in the audit (which may include a description of the auditor’s approach, a brief overview of procedures performed with an indication of their outcome and any other key observations in respect of the matter” (IFAC, 2016). The IAASB states that this results in the audit report changing from being standardized to being entity-specific (IAASB, 2015). The IAASB do not provide any examples of how KAM should be communicated, in order to reduce the risk of standardized audit reports. The presentation of KAM needs to deliver adequate information based on the auditor’s professional judgment. This should enable users to understand which areas are of most significance and how they have been addressed in the audit, which will result in the audit report being more entity-specific (IFAC, 2015). In turn, this contributes to increased communication value in the audit report, which also reduces the information gap (ibid). In addition to writing about KAM, the auditor should also discuss in detail their main responsibility during the audit, which the IAASB (2015) consider should also lead to a reduced expectation gap.

**The expectation gap**

The expectation gap can be described as the difference between the public expectations of auditors and the opinions of the audit industry on what auditors should do (Grönbok, 1996). The perceived expectation gap is that users often expect more from auditors than what they actually provide in the audit (Carrington, 2014). Lee, Ali and Bien (2009) state that these expectations exist due to users’ limited knowledge of the auditor’s role. The users tend to expect auditors to confirm that all entries in the financial statements are correct. However, auditors are only able to guarantee the correctness of the company’s financial statements to a limited extent (ibid).

The standardized audit report received significant criticism, since it was not informative enough on the subject of the auditor’s role (Carcello, 2012; Coram et al., 2011). Church et al. (2008) argue that
the standardized audit report does not have a communicative value but rather a symbolic value, and one reason is that information about the auditor’s role is limited. Thus, information is available about the auditor’s role but it has a weak information value for users (Vanstraelen, 2011).

Koh and Woo (1998) and Boyd et al. (2001) argue that an extended audit report with further information about the auditor’s role can contribute to reducing the expectation gap, since the auditor’s responsibility will be clarified in the audit. This idea is supported by Deloitte (2016b) and the IAASB (2015), who state that the new audit report should assist in reducing the expectation gap since what auditors have reviewed in the audit will be far clearer. However, Vanstraelen et al. (2011) have shown skepticism towards KAM’s ability to reduce the expectation gap, since users that are not aware of the auditor’s responsibilities will always exist, even if additional information is offered in the audit report.

The information gap

The information gap can be explained as the lack of information that users consider to be useful for making responsible investment decisions published in the company’s financial statements (IAASB, 2015; Barker, 2002). To counteract the information gap, the IAASB, among other changes, developed ISA 701-KAM. Auditors emphasizing the areas of highest importance in the financial report facilitate investment decisions for investors (IAASB, 2015). However, some studies indicate that the amount of information provided in the audit report has a minor impact on decision making situations for users. Mock et al. (2012) emphasize that extended audit statements do not necessarily result in more information value in the audit report. This can be linked to Cong and Pflugrath (2008), who also argue that the actual information value does not increase with the amount of information in the audit report, since this can contribute to added dissimilarities among users and auditors. The reason for this effect is that it can be difficult for users to understand an audit report with extended information. Furthermore, Chen et al. (2013) present recent research indicating that when investors are overloaded with information they choose to ignore it.

This view is not shared by Soltani (2000) or Loudder et al. (1992), who reason that auditors’ opinions are of great importance to investors when making investment decisions. This view is also taken by KPMG (2013) and Litjens et al. (2015), who add that an extended audit report should contribute to narrowing the significant information gap since those areas that have received most attention in the audit, such as those categorized as being essential risks or as being the most complex in the audit, are disclosed. However, Gutierrez et al. (2016) oppose this view and argue that the information disclosed by auditors can be uninformative for investors. This is since the risks that are disclosed might not
describe the relevant risks for investors, and therefore fail to meet the investors’ need for information. Lennartsson (2015) has a similar view in this regard, and states that even though the audit report will contribute more information, it will not reveal information that is relevant for investors. This is since “the auditor is a reviewer and not an information provider” (Lennartsson, 2015). He also emphasizes a conflict faced by auditors; they are expected to provide more information through KAM, but at the same time they are prevented from disclosing information that is not known due to the risk of damaging the company (ibid).

The standardized audit report

Some researchers argue that it is easier for users to understand standardized audit reports, because the auditor clearly states whether the audit is unqualified or qualified (IOSCO, 2010; Carrington, 2014 and Bailey et al., 1983). This reduces the risk of users misinterpreting the report’s content (Bailey et al., 1983) and of auditors influencing users’ interpretations, since areas of complication and risks faced by companies are not addressed (Hatherly et al., 1998). In audit reports with extended audit statements, auditors choose which areas to disclose; in turn, this can have a negative impact on users’ perception of the company (Hatherly et al., 1998). Other researchers claim that such audit reports can lead to uncertainty, since the amount of information can be overwhelming for users. This can result in the reduced relevance of the audit, since it may be complex for users to find the most relevant parts in the report. In comparison with the standardized audit report, the conclusion is easy to understand since auditors state whether the audit report is unqualified (Chen et al., 2013; Church et al., 2008; Sirois et al., 2016). Chen et al. (2013) argue that the amount of information in an audit report with extended audit statements, as required by KAM, will make it difficult for users to interpret the audit report. The authors argue that as a consequence KAM should be restricted, because the audit report should not contain a vast amount of information which could overshadow the important content (ibid).

However, according to Carrington (2014) the standardized audit report has been extensively criticized. Its critics believe that the standardized design of all unqualified audit reports looks the same, which limits the information that the audit report is supposed to convey (Carrington, 2014). In addition, the standardized audit report is criticized for being insignificant because of the limited information provided about how auditors have reached their conclusions (Humphrey et al., 2009). Instead, the standardized audit report consists of standard texts which contain little information about the audit itself. This leads to a reduced interest in reading the audit report for users, since they may struggle to understand the content (Brännström, 2012). This idea is supported by Power (1997), who believes that the audit report must move away from the standardized design in order to capture the reader’s attention.
and make it more useful. This belief is shared by Hjelström (2015) and Brännström (2012), who state that the biggest shortcoming of the standardized audit report is its generalized design, which makes it “a one-size-fits-all product”. Litjens et al. (2015) point out that a tailored audit report is always for the benefit of its users, since more relevant and specific information can be captured. However, Sirois et al. (2016) argue that the new standard will be affectless in regards of being tailored to each company, since entity-specific information only reflects a small portion of the audit report compared to the rest of the information. Lennartsson (2015) agrees on this matter and states that the audit report will still be standardized to some extent, since KAM is a small part in comparison to the rest of the information in the audit report. Furthermore, Catasus et al. (2013) argue that it can be difficult to move away from standardized audit reports and make information entity-specific, since auditors are accustomed to working under strict regulations and guidelines. This can create an underlying uncertainty among auditors to expose information as required by KAM, since there is a risk that such information could hurt the company (FAR, 2013).

**The effects of KAM in the audit report**

To date, knowledge of the effects of KAM in practice are limited due to the implementation of ISA 701 at the end of 2016. However, the Financial Reporting Council (FRC) in the UK introduced a similar standard in 2013. Auditors from the big four firms were required to produce more entity-specific audit reports by providing transparent information, such as a description of the potential risks of material misstatement, how the resources in the audit were allocated, and a summary of the audit scope (FRC, 2015).

Two years later, in 2015, FRC disclosed a review describing the effects of the new standard in practice. An overview of the survey revealed that auditors had met and exceeded the standard requirements of the new standard. Auditors had been innovative and every company had adopted different approaches to the extended audit report (FRC, 2015). Additional effects were that the auditor’s opinion was presented at the beginning of the audit report instead of at the end, addressing ongoing concerns and reporting on detailed audit findings with respect to the identified risks. Furthermore, the survey also indicated which areas required further improvements. These included increasing the granularity of risk reporting, more clearly linking the discussions of risks and materiality, and providing a description of how these risks influenced the scope of the audit (FRC, 2015).

According to the Institute of Directors in Southern Africa (IODSA), situations can emerge whereby the auditor believes that an issue relating to the audit is one of the most significant issues and that it
should be described as a KAM, but it has not been described by the company. This can result in stakeholders questioning why the management did not provide transparency on the issue in question in the financial statements (IODSA, 2015). Vanstraelen et al. (2011) argue that some stakeholders can perceive financial statements to be less transparent than the audit report, which could result in stakeholders preferring to consult the audit report rather than the financial statements. This can result in significant issues in the financial statements being disregarded. According to Deumes et al. (2012), auditors have argued that audit transparency can improve confidence in the audit since transparency can increase stakeholders’ confidence in financial statements. IODSA (2015) also argue that more information helps users to better understand the company, since transparency could improve the information value of the financial statement and the auditor’s report, and thus increase market confidence.

Auditors’ attitude towards an extended audit report

According to Öhman (2007), several auditors have a negative attitude towards an extended audit report, because it requires auditors to make statements about complex areas of the audit. This is considered to be difficult, as it requires auditors to be careful with the information they provide in order to avoid harming the company. Auditors therefore prefer a standardized audit report due to the increased difficulty to produce reports with extended statements. However, auditors should be aware of the fact that an extended audit report can be beneficial for users, as extended audit statements about the company’s financial situation can be useful when making investment decisions. This indicates a contradiction between what auditors feel comfortable writing about and what is considered important for users (ibid).

Furthermore, Deloitte (2016a) emphasizes that a number of challenges need to be overcome in the new method of writing the audit reports. It will be difficult to identify KAM if not already disclosed by the company, since auditors are not permitted to disclose any new information. Furthermore, Deloitte (2016a) stresses that it will also be challenging to write about KAM in a succinct and understandable manner while maintaining its relevance. In turn this process will be time-consuming, since the audit report will have to undergo quality assurance processes.

The confidentiality duty

The definition of TCD is: “A professional accountant should respect the confidentiality of information acquired as a result of professional and business relationships and should not disclose any such information to third parties without proper and specific authority unless there is a legal or professional
right or duty to disclose.” (IFAC, 2006). Confidence is the key to all essential information required for the ability to perform quality work. The auditor should not disclose information about the company to third parties, and if there is any suspicion of this there is a risk that the auditor’s confidence could be challenged (FAR, 2013). Humphrey et al. (2009) explains that TCD is essential for auditors to gain trust from their clients, which in turn affects auditors’ valuations in the audit report in regards to their statements. If auditors make statements that are considered by the clients as overstepping TCD, the effects could include the auditor losing their right to sensitive information since they are perceived as untrustworthy; this could result in the auditor losing their client. Adams et al. (1995) performed a study investigating how auditors are affected by TCD when they possess information that could benefit users, but that is also risky to present since it could overstep TCD. In the study the authors present the example of a client who sought a large loan and who was unaware of the company’s weak position, which the auditors were aware of. 78 percent of auditors were not willing to disclose the information, despite their knowledge of the users’ benefits if they were to receive it. Evidently, the auditors were more protective of TCD than of providing useful information to the stakeholder (ibid).

According to IFAC (2015) the implementation of KAM can bring about uncertainty between auditors and their clients. Auditors are put in a difficult situation, since they have to disclose more information but at the same time they must be careful not to disclose information that could harm the company (IFAC, 2015; Lennartsson, 2015). Vanstraalen et al. (2011) argues that auditors are willing to disclose the further information required by KAM as long as it does not overstep TCD. However, there is a fear of exposing too much information in efforts to meet the standard setters’ requirements (Vanstraalen et al., 2011). This could lead to the information disclosed by auditors containing boilerplate language that is not sufficiently informative, to protect themselves from dismissal or litigation (Lennox et al., 2016). This is in line with FAR (2013), who argue that ISA 701-KAM can contradict the ethical norms and professional values of TCD. EY (2013) also state that KAM can lead to a higher risk of impacting the client relationship, since the auditor could disclose information that the management might take issue with being released.

**Summary of the literature review**

The previous audit report received significant criticism because of its standardized design, which its users were dissatisfied with. Critics believe that the standardized design in all unqualified audit reports look the same, which limits the information that the report is intended to convey (Carrington, 2014). In addition, the standardized audit report is criticized for being insignificant because of the limited information presented by auditors on how they have reached their conclusions (Humphrey et al., 2009).
Users have therefore requested more information and transparency in the audit report, in order to acquire more relevant and useful information (Carcello, 2012). To meet the users’ demands the IAASB decided to implement a new standard, ISA 701-KAM, with hopes to make the audit report more tailored and entity-specific to each company. Accordingly, all listed companies in Sweden were required to implement KAM. Through KAM, auditors highlight the most complex areas of the audit and categorize the essential risks, to make the audit report more valuable to the users (IAASB, 2015).

However, thoughts on this subject in the literature vary; some researchers believe that the new standard will provide more useful information, while others believe that it will complicate the usability of the audit report. Koh and Woo (1998) and Boyd et al. (2001) propose that more information in the audit report would be to users’ advantage, since the extended text would clarify auditors’ responsibilities. However, Cong and Pflugrath (2008) and Chen et al. (2013) argue that more information could increase the risk of relevant information disappearing, since it could become difficult to interpret and it could be challenging to find the most relevant parts in the audit report. However, other researchers believe that more information would increase the usability of the audit report for users, since they will be able to capture relevant and specific information in the audit report. In turn, this should facilitate users to make investment decisions (Soltani, 2000; Loudder et al., 1992; Mock et al., 2012; Litjens et al., 2015; KPMG, 2013). However, Mock et al. (2012) Cong and Pflugrath (2008) argue that the amount of information in the audit report will have a small affect on decision-making situations, because auditors have to remain within the regulatory framework, i.e. TCD. As a result, the information in the audit report might contain boilerplate language that is not sufficiently informative, since auditors need to protect themselves from dismissal or litigation (Lennox et al., 2016). FAR (2013) take a similar view, and argue that KAM can contradict the ethical norms and professional values of TCD. This is because auditors have to provide more information through KAM but at the same time they must not disclose information that is not already disclosed, in order not to damage the company (Lennartsson, 2015).
Some researchers are supportive of the new standard and believe that KAM can contribute to more transparent and entity-specific audit reports, while others believe that the significance of the audit report could be reduced. This is because auditors are not permitted to state an opinion that could damage the company; this could lead to auditors feeling less secure with their responsibility to write an audit report comprising further statements on the company’s financial statements, because of the fear of overstepping TCD (FAR, 2013; EY, 2016; Humphrey et al., 2009; Guénin-Paracini, 2014; Adams et al., 1995; IFAC, 2015; Lennartsson, 2015 and Vanstraalen et al., 2011).

Figure 1. Analysis model
Method

This chapter starts by presenting the methods chosen for this study. The sample of respondents is then presented before a discussion of the operationalization, describing how the empirical findings were analyzed. In addition, ethical aspects, validity, reliability and criticisms of the method are raised. The chapter ends with the delamination of the study.

Research design

In this study we chose to use a qualitative approach, since the audit industry is in constant change and is affected by social circumstances. The qualitative approach questions that social circumstances are predetermined, and instead considers that they result from social interactions and are therefore constantly changing (Bryman, 2015). Auditors are continuously influenced by social factors such as customer relationships, conflicts of interest and their own incentives, which can affect how KAM is interpreted in the audit report.

Since this study aims to achieve an understanding of the auditors’ interpretation of and attitude towards the new standard, the interpretivist point of view is also suited to this research. The interpretivist approach is based on understandings and interpretations, so it requires a method that takes human and social actions into consideration (Bryman, 2015; Denscombe, 2016). Furthermore, Bryman (2015) state that in a study conducted by an interpretivist approach the researcher is both providing and gaining new knowledge. By creating an understanding of how auditors have interpreted and applied KAM in practice, this study contributes to new knowledge that has not previously been studied in a Swedish context.

In addition, the approach of this study is also inspired by an exploratory outline, since it explores a new way in which auditors write the audit report. Notably, the literature in this area is limited since ISA 701-KAM has been implemented recently, and in most cases the previous research is based on speculation; the purpose of this study is thus exploratory by nature. Since we explore how auditors interpret the new standard in practice, we are also able to identify new issues that can occur when writing an audit report with extended audit statements (Bryman, 2015). The exploratory approach also enables researchers to contribute developed research to add to theoretical knowledge (Saunders et al., 2012). In this case, the research relates to the information value of audit reports with extended audit statements.
Data collection

As mentioned in the previous section this study uses a qualitative approach, which aims to provide a broad and fundamental understanding of respondents’ interpretations in depth (Holme and Solvang, 1997). The data was collected through semi-structured interviews to allow new questions and ideas to be discussed during the interview (Bryman, 2015). Interviews were conducted at each respondent’s office in Stockholm or Uppsala in order to carry out face-to-face interviews. In this way, the interviewer is able to ask follow-up questions to obtain a broader understanding of the respondent’s interpretations (Bryman, 2015). This method gives an opportunity for the respondents to talk freely and give thoughtful answers to the interview questions. Furthermore, semi-structured interviews allow researchers to have an open conversation with the respondents, where they can express their thoughts more freely when asked to develop their thoughts in more depth. This has contributed to a greater understanding of how the respondents have interpreted and applied KAM.

To gain an enhanced understanding and a better insight of an audit report with extended audit statements, we also use existing information in the field. This search process was conducted by searching for relevant literature, scientific articles and reports, primarily through the database of Uppsala University and with the use of FAR, Balans and the IAASB website. When searching for information the main keywords were: “audit report”, “key audit matters”, “information gap”, “expectation gap” and “the confidentiality duty”.

All interviews were carried out by two interviewers; one had an active role and posed questions to the respondents, while the other was passive and made notes. This interview technique was used to save time when transcribing the collected data.

Sample of respondents

Since only listed companies have applied KAM, we chose to interview authorized public auditors from PwC, EY, Deloitte and Grant Thornton. These firms audit the majority of the listed companies on the Stockholm stock market, which made auditors from these companies natural choices to interview. The first step to obtain respondents was to visit each audit firm’s website and contact the company to ask if any auditors were willing to take part in our study. Although some respondents expressed willingness to answer our interview questions, we were not satisfied with the number of respondents. Therefore, following each interview we asked the respondents if they had any recommended colleagues who we could contact. The respondents provided names of other authorized public auditors who we then contacted; through this approach we increased the number of respondents from 6 to 10.
All of the respondents in this study possess substantial knowledge, since they have many years of experience in the profession, and are therefore likely to be able to handle the issues that can arise in an audit. We interviewed 10 auditors with different backgrounds. This made it possible to individually analyze the information to gain a broader perspective of the field, in order to fulfill the purpose of the study. The duration of the interviews was between 35–60 minutes.

The interview questions were based on the theoretical framework of this study, to collect different views on various issues presented in the previous research and thus to create an objective view. Furthermore, the interview questions were sent to respondents before the interviews took place, so that they could prepare for the interview. This contributed to more reliable and more thoughtful answers from the respondents.

The following table characterizes the sample of respondents, in which R = respondent, SME = small- and medium-sized companies, PLC = public large companies and y = years.

The respondents are listed in the same order as they were interviewed.
### Table of respondents

<table>
<thead>
<tr>
<th>Respondent</th>
<th>Employer</th>
<th>Title</th>
<th>Audits</th>
<th>Experience (y=years)</th>
</tr>
</thead>
<tbody>
<tr>
<td>R1</td>
<td>Grant Thornton</td>
<td>Public authorized auditor</td>
<td>SME</td>
<td>30 y</td>
</tr>
<tr>
<td>R2</td>
<td>Grant Thornton</td>
<td>Public authorized auditor</td>
<td>SME &amp; PLC</td>
<td>38 y</td>
</tr>
<tr>
<td>R3</td>
<td>PwC</td>
<td>Public authorized auditor</td>
<td>PLC</td>
<td>33 y</td>
</tr>
<tr>
<td>R4</td>
<td>PwC</td>
<td>Public authorized auditor</td>
<td>SME &amp; PLC</td>
<td>27 y</td>
</tr>
<tr>
<td>R5</td>
<td>PwC</td>
<td>Public authorized auditor</td>
<td>PLC</td>
<td>26 y</td>
</tr>
<tr>
<td>R6</td>
<td>Deloitte</td>
<td>Public authorized auditor</td>
<td>PLC</td>
<td>13 y</td>
</tr>
<tr>
<td>R7</td>
<td>EY</td>
<td>Public authorized auditor</td>
<td>SME &amp; PLC</td>
<td>23 y</td>
</tr>
<tr>
<td>R8</td>
<td>PwC</td>
<td>Public authorized auditor</td>
<td>SME</td>
<td>21 y</td>
</tr>
<tr>
<td>R9</td>
<td>Deloitte</td>
<td>Public authorized auditor</td>
<td>PLC</td>
<td>28 y</td>
</tr>
<tr>
<td>R10</td>
<td>EY</td>
<td>Public authorized auditor</td>
<td>SME</td>
<td>31 y</td>
</tr>
</tbody>
</table>

*Figure 2. Table of respondents*

### Operationalization

The interview questions were divided into themes to give them a clear structure, to facilitate analysis of the empirical findings. Denscombe (2016) states that dividing interview questions into themes is effective because it simplifies analysis of the collected data and comparison of the answers. This study uses four different themes. The interviews started with open questions and successively became more focused and detailed (this is described in more detail in the next paragraph). This is a common way to begin an interview because it helps respondents to feel comfortable and less exposed, which leads to a natural dialog (Patel and Davidson, 2003; Kykan, 1994). By using themes, we were able to see similarities and differences in the auditors’ answers, which made it easier to make connections with our theoretical framework and to draw conclusions related to the study’s research question.
The first theme has a general character, whereby we asked the respondents general questions about their title and position, their years of experience and which types of clients they review. These questions relaxed the respondents so that we could have an easy conversation about the implementation of KAM. The second theme raised questions about the new audit report and the responsibility that has developed with ISA 701-KAM. In this theme, the questions were more specific and straightforward, since they were focused towards the respondents’ opinions on KAM. The third and fourth themes were also of a more specific character, whereby we asked the respondents questions about the trade-off between TCD and ISA 701, and about the effects on their client relationships. All of the interview questions were constructed to gain a broad understanding of how respondents have interpreted and applied ISA 701-KAM in the new audit report.

After each interview, all collected data was transcribed and sent to the respondents to avoid any misunderstandings in the empirical findings. The respondents then confirmed that the information was in line with their responses. The respondents were also given the possibility to correct any misunderstandings if necessary, in order to increase the study’s credibility. All of the interviews were recorded, as recommended by Bryman (2015). Recording the interviews allowed us to return and listen to the respondents’ answers. The answers were also written down to save time when the collected data was transcribed. To increase the reliability of the study we saved all material gathered during the interviews, including recorded interviews and written notes.

The transcribed answers of the respondents are the grounds for the results and analysis of this study. After each interview, we summarized the answers and returned them to the respondents to avoid any misinterpretations, as mentioned above. After the respondents had approved their answers all data collected through the interviews was summarized in a separate document, which can be found in the summary of empirical findings presented in the next chapter. After each interview, we drew links between the respondents’ answers and previous research, to identify which similarities and dissimilarities exist between our results and the previous literature. Subsequently, we performed an analysis of these results to obtain a broad and inherent understanding of the auditors’ interpretations of KAM. The analysis started by mapping all of the answers to each theme. An overview of all transcribed answers was thus created. However, the main purpose of this stage was to enable returning and following up each interview, to compare answers and identify the similarities and dissimilarities in the respondents’ answers. Comparing the results of the empirical findings allowed us to reach a conclusion to our study, since most of the respondents share a common view. The analysis of the empirical findings is the basis for the conclusion of this study.
**Ethical aspects**

It is important to consider individual protection requirements while conducting interviews, which involve the interviewee receiving protection against violation, psychological or physical damage during research (Vetenskapsrådet, 2002). This study takes four different research requirements into consideration raised by the research council: information requirements, approval requirements, confidentiality requirements and utilization requirements. To fulfill the information requirements, we informed the respondents of the study’s purpose and research question before the interview took place. They could then decide whether they wanted to participate. The approval requirements demand that researchers obtain respondents’ approval before publishing the information gathered from them (Vetenskapsrådet, 2002). Before publishing this information, we asked respondents if our interpretations of their interview were in accordance with their answers. They were also given the opportunity to correct any misunderstandings. To meet the confidentiality requirements, all respondents’ names were assigned numbers to retain their anonymity. In this way, respondents could be more honest when answering interview questions, thus increasing the validity of this study. We clarified to all respondents that the gathered information would only be used for the purpose of this research, as demanded by the utilization requirements.

**Validity and reliability**

According to Holme and Solvane (1997), the validity of a qualitative study is based on the number of respondents involved. We interviewed 10 respondents, which we believe is a good starting point to answer the research questions since the majority of respondents share a common opinion of the new standard. This has resulted in significant responses that can be used to answer the study’s purpose and research question, and indicates that a large number of respondents would not change our results to a significant extent. The respondents also have different backgrounds, since they review both PLC and SME companies in different industries on the Stockholm stock market. This enabled us to obtain a broader understanding of how auditors have interpreted and applied KAM in the audit report.

All of the interviews were recorded, which increases the reliability of the study. This also made it easier to analyze the collected data and reduced the risk of information being misconstrued. According to Holme and Solvang (1997), it is beneficial to record interviews since the gathered data is saved and the author is able to return and re-listen to interviews. However, there is also a disadvantage to recording interviews; respondents could feel uncomfortable about answering questions while being recorded, which could contribute to them being reserved. This could in turn result in important
information not being disclosed by respondents (Holme and Solvang, 1997). This has been taken into account in this study; all of the respondents were informed in advance that they are anonymous, which contributed to less reserved behavior during the interviews.

**Criticism of methods**

As mentioned above, we distributed the interview questions in advance to obtain more thoughtful and reliable answers. However, this can also have a downside since sending out the questions beforehand could result in more standardized answers from the auditors, which could impact the outcome of the empirical findings. Furthermore, since KAM has been implemented recently the experience is new for auditors. Therefore, the results of our empirical findings could differ in future research when auditors have more experience. Furthermore, we conducted 10 interviews with authorized public auditors, which is a fairly small number of respondents. Consequently, the results of our study cannot be used to represent the whole audit industry in a broader context.

**Delimitations**

We chose not to include stakeholders’ perspectives, since KAM has been implemented recently and has not yet reached stakeholders. Their perspectives would therefore be based on speculations, which would reduce the credibility of the study.
Empirical findings

This chapter presents the empirical findings of this study, and begins with a discussion of the respondents’ thoughts regarding the previous audit report and its purpose in comparison with the new audit report. These discussions progress to auditors’ attitudes towards the new audit report and how TCD might have affected their statements. The chapter ends with a summary of the empirical findings.

To engage in a natural dialog with the respondents, all interviews started with general questions about the previous audit report and its purpose in comparison to the new audit report. All of the respondents agreed that it fulfilled its purpose, which was to administer a quality stamp regarding whether the information presented in the financial report reflected the financial position of the company. However, there were different views on whether the audit report has been improved by extended audit statements. According to R2, R3, R5, R6, R7 and R10 the new audit report is better to some extent due to the opportunity to be more informative. Auditors are now given the chance to make the audit report more adaptable to each company; consequently, it is more comprehensive and user friendly than the previous report (R6). The previous audit report contained a substantial amount of body and standard text, which made the information difficult for users to understand. Information relating to the auditor’s and the management’s responsibilities was perceived clearly by people with a higher level of accounting knowledge, but it could be difficult to understand for those with lower levels of knowledge (R6). This mostly resulted in neither the clients nor the public reading the previous audit report, since its relevance was lost in the vast amount of information (R4).

The majority of respondents mentioned that the previous audit report needed improvements since it was not informative enough and contained too much standard text, which did not convey valuable information to users. The new audit report is an improvement, since auditors can be more informative and entity specific than previously through KAM (R2, R3, R5, R6, R7, R9, R10). Important areas are raised, which makes it easier to identify the most essential and complex areas with more assessments in the audit (R6). According to R10, this has contributed to users being able to immerse themselves in the financial statements and understand the areas of complexity. However, the respondents consider that the new audit report requires further improvements. It contains a lot of standard text and “audit language” which still makes it difficult for users to understand and find the important information they need to make investment decisions (R2, R3, R6, R4, R7). This is supported by R1, who argued that the reading value decreases when it becomes a multi-page document, since there is a risk that it contains too much information for users to interpret. The audit report is very important for banks and
other large companies that make credit decisions, since the information within is valuable to approve credit applications. However, since it contains so much information it becomes difficult to find the most relevant parts. This could be improved by structuring the standard text in bullet points and by referring to the regulations (R1).

**Identifying KAM in the new audit report**

All respondents agree that KAM relates to difficult and complex entries, and requires a lot of assessments. These entries have a significant impact on financial reporting, and if they go unnoticed there can be major consequences on the company’s balance sheet and income statement. Over the years auditors have always reviewed these types of entries, which means that the underlying work required for the audit has not changed. The difference is that while previously auditors only reported KAM during annual meetings, it is now more transparent externally since it is included in the audit report. In other words, there is nothing new in the audit since it has always been risk based.

All respondents mention that a risk analysis is performed in an early stage to identify the areas of greatest significance in the audit. Thereafter, auditors ascertain the entries that will require significant judgments and estimations, since these entries carry the highest complexity and are time consuming. According to R2 these entries can require future estimations, which are certainly the most difficult to work with because it is difficult to predict the future state of the market. When the focus and risk areas have been identified, in an early stage an audit plan is presented to the audit committee and the management which presents how KAM will be communicated in the audit report. However, these can change over the year, since changes can occur in the company that lead auditors to change their focus and risk areas. Once auditors have established the final KAM together with their audit team, people outside the team control and ensure that KAM is of a high quality, well formulated and within regulatory frameworks and standards before the audit report is published (all respondents).

**Challenges in communicating KAM**

Although auditors believe the implementation of KAM has made the new audit report better than the previous one, it has also brought challenges. The most challenging part of communicating KAM has been to formulate it in a way that is understandable for users, as it is easy to become caught up in professional terms and audit language that consists of standardized terms and concepts. It is difficult to understand the full extent of the problem and present it in an understandable way (R3, R5, R6 R4, R9, R10). There is also a risk that KAM could be misinterpreted if auditors provide too much
information, while if too little information is given the users may not understand the content of KAM; achieving this balance is difficult (R5). This is supported by R8, who said:

“It is difficult to express myself because I am writing to so many people that have different knowledge and read the report in different ways. As an auditor you should provide information without exposing too much, but also write in a precise way that is readable for a large group of readers. You always have in mind that the information can be misinterpreted and therefore you need to weigh the words on an assay balance, which is challenging.” (R8)

The new standard requires auditors to write down what has previously been orally presented during annual meetings. Writing down information that has previously been said orally is another challenge, since it is possible to verbally indicate shortcomings in the company without exposing too much information. This has become even more challenging since it is difficult to indicate issues in written form, as this can be used against you if the information is misinterpreted (R1). Consequently, issues have to be worded carefully to ensure the right balance. KAM needs to be written in a clear language in order for its content to be understandable for users (R4, R9, R10). Furthermore, all of the respondents raised that it has become far more time consuming than before to produce an audit report, due to the need to review the content to ensure they have a good basis for their statements.

**The influence of KAM on the standardized audit report**

According to IFAC (2016), KAM should provide more relevant information for users, so that the standardized audit report becomes less standardized and should instead be entity-specific. However, respondents are skeptical about this matter since they believe there is a risk of the audit report being standardized to some extent, despite the implementation of KAM (all respondents). This is because auditors could read each other’s reports, as well as audit reports from the UK, and take formulations that they consider to be well formulated for use in their own reporting. This would enable auditors to present the information requested by users while remaining within the limits of how much they are able to present without expressing themselves in a way that could harm the company. This was confirmed by R6, who stated:

“We have glanced at some of the audit reports from the UK to see which areas were reported as KAM. What we have noticed is that there are some entries that are often communicated as KAM. This can for example be goodwill, which is often reviewed in the same way in all companies. This has made it possible for us to glance at their formulation when we write about goodwill as KAM in our audit
reports in order to use language that cannot be used against us. However, it is in our interest to create the most entity-specific audit report as possible.” (R6)

R2 also emphasized the risk of the audit report being standardized to some extent:

““There is a lot in ISA in terms of language and terms that we can steal which are actually correct, but when it comes to individual companies, it becomes standardized. I think a lot of auditors look at these terms used in ISA, since they are correct, but there is a risk that we overuse them. The outcome is that 10 different companies’ audit reports become the same since auditors have used the same formulations, which can limit the audit report from becoming entity-specific.” (R2)

Furthermore, the respondents expressed the risk that audit reports could be more industry-specific than entity-specific, since companies that operate in the same industry often have the same risk and focus areas. To some extent this will hinder the audit report from becoming fully entity-specific, as hoped for by the IAASB (all respondents). For example, when reviewing a retail business inventories are a focus area for all retail companies. However, there may be some aspect of the inventories that the auditor might place extra focus on and formulate in his own words, which would make the report slightly more entity-specific (R9). These arguments are supported by R4, who stated:

“I can imagine that audit reports are weaker in traditional growth companies that manufacture goods which are stored in stock. This is due to the fact that if companies do not have entries that stand out, the stock becomes a natural KAM in all companies, since it requires considerable focus in the audit. In these types of companies, the reports will look similar to each other. If you compare them with high-tech companies that have huge balance sheets, it will be a completely different case, since there are more entries that stand out. Therefore, I think that some reports will still be standardized and others more entity-specific. At the same time, I cannot see that there is anything that can be done about it.” (R4)

Furthermore, R5 believes that the audit reports from this year will be perceived as more entity-specific than in coming years, because risk areas do not change quickly in companies over the years. As a result, audit reports could be perceived as standardized if the same risks are defined as KAM for several years in a row. In turn this could lead to the audit report being considered as less entity-specific and more standardized (R5).
The influence of KAM on the expectation gap

The expectation gap is a phenomenon that has always existed within the audit profession. The majority of respondents perceived that the new regulation would have some impact on the reduction of the expectation gap. The reason for this is that the audit report has become clearer in regards to auditors’ responsibilities, and what they have reviewed and placed extra focus on (all respondents) However, there will always be users who believe that the auditor reviews all entries in the annual report and who lack an understanding of what auditors actually do (R8). Auditors cannot describe the most essential entries in the audit in minute detail, or why these entries have been reviewed, because they might expose too much information about the company’s entries; this could lead to auditors ending up in deep water. The users need to have some kind of financial knowledge to understand KAM in the audit report. Therefore, the expectation gap will still exist for those users who have limited knowledge of accounting (R10). Auditors can reduce the expectation gap to some extent, but this is very difficult to manage because users need a broader economic knowledge than the average person to understand auditors’ responsibilities in the audit (R3).

The influence of KAM on the information gap

The majority of respondents believe they have a responsibility to assist in reducing the information gap that exists today, but emphasize that this is not their primary responsibility. The main responsibility lies with the company, since they create the annual reports that should convey useful information for investment decisions. All respondents mentioned that the audit report does not include information that has not been described by the company. Instead, the auditor’s responsibility is to highlight those areas in the financial report that are considered of most importance for users to know. However, these areas cannot be described in detail, since auditors have a responsibility towards their clients not to formulate the report in a way that could harm the company.

R2 stated:

“The information that is disclosed must be relevant and adequate, so that users can make the right decision based on the given information. However, our responsibility is only to highlight those areas that we consider to be important for users and we are not able to disclose any new information that is not disclosed in the financial statements. This is a difficult task to balance since the information should be highlighted in an understandable way, and at the same time not be too descriptive in order to not overstep the regulation of TCD.” (R2)
Furthermore, R8 expressed that auditors have a responsibility to reduce the information gap as much as possible, since the public always want to identify the person in charge if something goes wrong and auditors are usually blamed, despite the fact that this is not part of their responsibilities. Therefore, it is important for auditors to help reduce the information gap by being pedagogical and clear in their statements in the audit report.

"Transparency gives confidence and our job is to provide information that gives a true and fair view of the company. Auditors should therefore secure the quality of the annual report by confirming that the information provided by the company is essentially correct." (R8)

Auditors have a social responsibility to bring more openness and transparency to the annual report, so that users can use the dispensed information. However, auditors need to present this in a careful way since they are not allowed to expose information that could be used against the company. Therefore, it is important that auditors consider their words carefully when KAM is formulated in the audit report (R2, R3, R5, R8, R9, R10).

The confidentiality duty

TCD has a strong connection to the audit and is a prerequisite for auditors to be able to perform an audit. Otherwise, clients would not disclose sensitive information to the auditor (FAR, 2013). However, all respondents expressed that KAM has somewhat opened up TCD since auditors are now able to communicate issues that could not be announced in the previous audit report. This indicates that auditors have gained more freedom. However, auditors must remain inside the legal framework of TCD, which means that they must be careful about how KAM is communicated.

All respondents also agreed that they are willing to disclose information in the most entity-specific way possible, as long as it stays inside the legal framework of TCD. However, this is a difficult task to fulfill since there is no clear information on how auditors are supposed to express themselves without the possibility of breaking TCD. R8 believes that before information is published in the audit report it should be reviewed, in order to confirm that no new information is being published or that the statements are not formulated in a way that could harm the company. R7 also emphasized that KAM should be formulated with much care, and stated:

"The confidentiality duty affects everything we do and we must therefore be careful when we choose how we express ourselves when something is negative in the company. We need to formulate ourselves in a way that makes it clear for the readers what the risks areas are, without being too
obvious. If we cause damage to the company, there is a risk that they could sue us and no auditor wants that. However, if KAM is implemented in accordance with the legislation, auditors do not have to be worried about breaking the confidentiality duty.” (R7)

Before choosing which areas are going to be defined as KAM in the audit report, auditors have a dialog with the company so that they are in agreement on which areas may be defined as KAM (all respondents). This is most easily done by the company writing about their risks in the annual report, since this opens up a platform with auditors about what can be communicated as KAM. If the auditor considers an area to be a KAM which the company has not chosen to write about, this results in a qualified audit report. Such a situation would be problematic, since TCD outweighs everything else (R7).

**Relationship towards clients**

All respondents emphasized that the implementation of KAM has not impacted their client relationships to any significant extent. The clients were proactively informed that the audit report would be extended in the near future to make them aware of the upcoming changes. The clients were provided with examples of how an extended audit report could look, based on the previous year’s annual reports. Discussions also took place about the extended audit report to answer any questions that the company might have (all respondents). However, the reaction and interest from clients has been lower than expected, perhaps because their main interest lies in the company’s business (R10). This is supported by R4, who stated that a greater reaction was expected from clients and that the new legislation would bring up more discussions. The respondents also explained that they were prepared for clients to request them to reformulate or tone down some statements in the audit report. However, this reaction has not yet been encountered, potentially because clients have great respect for auditors and therefore do not question what they write in the audit report (R4).

According to R1 the new legislation has contributed to better client relationships, because both parties are forced to have a more open dialog about sensitive areas of the company which could be published in the audit report as KAM. In other words, the new legislation has been worked through with clients to provide them with greater understanding and to reduce any uncertainties.
Summary of empirical findings

Overall, most of the respondents argued that the audit report has been developed for the better, because information is communicated in a clearer way than before. This should help users to gain a better understanding of the financial report than before, thus providing a clearer picture of the company’s financial position in the market. However, KAM entails challenges for the auditor in contributing new information expected by the IAASB to be published in the audit report as KAM. Respondents emphasized that it is important to formulate the report “correctly” so as not to break TCD. This requires auditors to consider their words carefully in order to provide more information without revealing too much, while writing in an understandable way so that users can understand the information defined as KAM.

Furthermore, the respondents argued that the standardized design would be reduced to a certain degree, but not to the same extent as hoped for by legislators. This is because there is a risk that auditors will look at ISA formulations and reports from the UK to be able to use language that minimizes the risk of causing harm to the reviewed company. In this way, the demand for more information can be met while auditors can remain within the scope of what is permitted to disclose in accordance with TCD. This indicates a limitation as to which extent the audit report can be entity-specific, since there is a fear among respondents of breaking TCD. Furthermore, R8 and R2 stated that the fear of breaking TCD also affects the extent to which gaps can be reduced, since they are limited to how descriptive their formulations can be for users to gain a better understanding of these concepts. These empirical results indicate that confidentiality has a major impact on how auditors will implement KAM in the audit report.
Analysis

In this chapter, we analyze our empirical findings in comparison to the literature review, in order to draw conclusions about the auditors’ interpretations of KAM.

The audit report is based on auditors’ interpretations of what they believe the audit should fulfill, which illustrates what they aim to present through the audit report. Therefore, the empirical findings of this study began by contemplating what the respondents believe is the purpose of the audit report. All of the respondents were in agreement about the purpose of the audit report, which is to supply a quality stamp regarding whether the information presented in the financial report reflects the financial position of the company. This is in accordance with FAR (2017), who state that the purpose of the audit is to secure the quality of the financial statements by confirming it in the audit report. This can also be linked to the principle–agent theory, which describes how auditors enter the company as a monitoring function to confirm that the company’s financial statements are correct, in order to reduce the information asymmetry between the owner, the investors and the management (Carrington, 2014; Watts and Zimmerman, 1979; Moore & Ronen, 1990). From the results of this study, we can therefore confirm that auditors perceive their role as a tool within companies for quality assurance, as the principal–agent theory describes. This indicates that during an audit, auditors have the intention to provide the most accurate possible picture of the company and to make the report as user-friendly as possible.

However, there were different views on whether the audit report has been improved by the implementation of KAM. Most of the respondents stated that to some extent the audit report has been enhanced due to the possibility of being more informative. However, respondents mentioned that the audit report still needs improvements, since it has become longer and still contains a lot of standard text and audit language, which can make it difficult for users to find and understand the most relevant parts of the audit. This can be linked to the studies of Chen et al. (2013), Church et al. (2008) and Sirois et al. (2016), who argue that too much information in the audit report reduces its relevance since users are unable to interpret that amount of information. This could be attributed to the increased difficulty of reading a multipage document than a document where the auditor’s conclusions are clear, as in the standardized design. Chen et al. (2013) also found evidence that when the audit report becomes a multipage document users tend to ignore it. By comparison of our results with the empirical findings, KAM as the legislator’s aim to give users more insight into the audit report can produce the opposite effect. This is since the majority of respondents in this study emphasized the risk of the new
The audit report becoming difficult to understand, since the extended text still contains many standard formulations that can be difficult to understand. The reason that auditors continue to use standard formulations is that they are very careful when making their extended statements, because of the fear of stating something that could hurt the company. In turn, this can make the language in the audit report difficult to interpret, especially if the audit report becomes significantly longer. The resulting risk is the audit report providing less information for readers who do not have a well-founded economic background to understand the audit language.

Furthermore, the IAASB (2015) has stated that the audit report will be tailored to each company, since the information will be entity-specific rather than standardized like the previous report. However, Lennartson (2015) believes that the audit report can still be standardized despite the implementation of KAM, which has also been confirmed by the respondents in this study. Although the empirical findings indicate that the audit report has become more entity-specific, the respondents were skeptical about to what extent the information is entity-specific; it may not be to the degree that the IAASB had hoped for. The reason is that auditors read each other’s audit reports and take formulations that are considered to be well formulated to use in their own reporting (the majority of the respondents), and there is a risk that auditors could steal and overuse terms and formulations from ISA (R2). According to Catasus et al. (2013) this can be explained by auditors being accustomed to working under strict regulations and guidelines, which could make it difficult for them to move away from standardized audit reports and provide more entity-specific information. Furthermore, the empirical findings imply that situations might occur whereby auditors use formulations from ISA to ensure that KAM is not formulated in a way that could cause harm to the company. From the above, we can draw the conclusion that the respondents have the ambition to provide more information to the users of the audit report, but at the same time they are not willing to jeopardize TCD and therefore continue to use standardized language. This can be connected with FAR, 2013; EY, 2016; Humphrey et al., 2009; Guénin-Paracini (2014); Adams et al. (1995); IFAC, 2015; Lennartsson, 2015 and Vanstraelen et al. (2011) who stated that TCD could lead to auditors less secure with their responsibility to write an audit report with further statements. This indicates that the risk of breaking TCD weighs heavily on auditors and limits to what extent they can contribute to entity-specific information in the audit report. This can be explained by the fact that consequences are worse for violating TCD than for failing to provide entity-specific information, which might be the reason why auditors prioritize TCD ahead of KAM. In addition, auditors are used to working under strict regulations, so it can be difficult for them to know to what extent they can add more specific information in the audit report.
The results of the empirical findings also show that it has been challenging to formulate KAM in clear language that is understandable for users. The majority of respondents argue that it is easy to get caught up in audit language, terms and concepts, in line with the opinion of Deloitte (2016) that it is challenging to write about KAM in a succinct and understandable way while keeping information relevant for users. Too much information can mislead users, while too little information can prevent users from understanding the content of KAM. The conflict lies in that content being misinterpreted by users could affect the company negatively, which could lead to serious consequences for the auditor’s career. This indicates that TCD is an underlying factor when respondents reflect on how to present KAM in the audit report. According to the respondents of this study, this could lead to a situation whereby it is far more time consuming to produce an audit report than the standardized audit report. This is in line with the study of Öhmans (2007) which demonstrated that a standardized audit report is easier to produce since it only provides the information of whether the audit report is unqualified.

According to the IAASB, auditors should consider different aspects when communicating KAM in the audit report, such as areas that require significant auditor attention, the company’s potential risks, and how these risks were managed. This means that entries considered as time consuming and complex during the audit review should be defined as KAM in the audit report (IFAC, 2016). The results of this study suggest that all auditors were in agreement about KAM being related to the entries that demanded most of their attention during the audit and that were time consuming, alongside the company’s potential risks and an explanation how these risks were managed. This mean that the standard setters and this study’s respondents agree on what KAM is and how it should be described. There have not been any disagreements over this matter, which is probably due to the fact that auditors have always reviewed these types of entries. The only difference is that they are now written down instead of being communicated orally at the Annual General Meeting, as mentioned by the respondents in this study.

With regards to KAM reducing the expectation gap, the majority of respondents perceived that KAM would impact on the reduction of the expectation gap. This is because the audit report has become clearer in regards to auditors’ responsibilities and what they auditors review. Koh and Woo (1998), Boyd et al. (2001) and Deloitte (2016) also highlight this, since they believe that more information in the audit report will assist in reducing the expectation gap. However, it can be difficult to reduce the expectation gap, possibly because users will always exist who misunderstand the auditors’ responsibilities, which prevents the expectation gap from being fully reduced. Furthermore, to some extent the auditor’s responsibility is still described in the standard text, which limits the ability to understand and interpret auditors’ responsibilities. However, the extended text should be more
manageable for those with a strong financial background since the responsibilities will be described in more detail, and therefore the expectation gap should be decreased among those users.

However, in terms of the information gap being reduced the results show that auditors do not consider this to be their primary responsibility, since they believe it is the management’s task to provide users with useful information. The respondents stated that they could take part in reducing the information gap since KAM enables them to be more transparent, as it raises areas of great importance. In turn, this facilitates users to see the most essential parts in the audit (R2, R3, R5, R6, R8, R10). This can be linked to Litjens et al. (2015), who stated that users’ demands can be met by auditors communicating what is of most importance in decision making situations. This can be achieved by clarifying which areas received most attention in the audit, for example those areas categorized by essential risk. However, the majority of the respondents highlighted that auditors cannot express themselves to the same degree as they might wish, since they have to consider TCD, which limits them when making statements about the company’s potential risk in the audit. As a result, the auditors are hindered by the framework of TCD when KAM is formulated in the audit report, so they cannot be as specific as the users and the regulators want them to be.

FAR (2013) has stated that KAM can stand in contrast with the ethical norms and professional values of TCD. Auditors have to provide more information through KAM, but at the same time they must not disclose information that is not already known in order not to damage the company (Lennartsson, 2015). All of the respondents confirmed that even though KAM requires auditors to be clearer when describing risk areas, there is still a need to be careful with the chosen formulation of the audit report so as to avoid damaging the company. This can be linked to Öhman (2007), who also stated that it is difficult for auditors to write an audit report with extended statements since it requires them to be careful with the information they give. In order to reduce the risk of damaging the company, the respondents argued that it is easiest to allow the company to write about the risk areas in the annual report, since this opens up a platform about what can be communicated as KAM in the audit report. However, all of the respondents emphasized that TCD has been slightly loosened through KAM, as auditors are now able to communicate about issues that previously they were not able to announce. However, it is important to consider that auditors still need to fall inside the frame of TCD, as they cannot formulate KAM in a way that could hurt the company. Therefore, auditors should avoid writing anything that is not already known in the financial statements (All respondents). This indicates that TCD has a large impact on what auditors decide to comment on in the audit report.
The respondents have not experienced impacts of KAM on their client relationship to any significant extent. According to the respondents, their clients have been proactively informed that the audit report would be expanded in the future and have been given examples of how the audit report could be designed, in order to raise awareness of the upcoming changes (all respondents). As previously mentioned, auditors are careful when writing KAM; this could be one of the reasons why the respondents have not experienced any contrast between KAM and their client relationship.
Conclusions

This section presents the conclusions of this study and suggestions for further research.

The purpose of this study is to create an understanding of how auditors have interpreted and applied KAM in the new audit report. The results demonstrate that overall the respondents have a positive view of the implementation of KAM, since most of them expressed that the current audit report is an improvement on the previous one. However, the implementation of KAM has come with difficulties in regards to its application in the audit report, because auditors have experienced that the regulation of TCD hinders them from expressing themselves to the same degree as the standard requires.

The results of this study also show that auditors have more respect for TCD than for writing entity-specific information in the audit report. Consequently, the statements required by KAM are limited since auditors are highly aware of not taking the risk of overstepping TCD. Furthermore, the results also indicate that auditors are restrained to some extent in terms of how much entity-specific information they can provide in the new audit report, since they are unsure of how specific they can be without harming their clients. According to the results, cautiousness exists among auditors when formulating the audit report. This could impact the new standard’s intention to move away from a standardized design; instead, the report could be perceived as standardized. All of the respondents expressed that they formulate KAM with a great deal of care in the audit report. Every printed word is carefully expressed in order to avoid entering a zone that could invite questions of whether they have breached the TCD. This indicates that the respondents’ willingness to write about specific information in the audit report is limited, due to the fear of crossing their clients and ending up in lawsuits. Since TCD is a prerequisite to perform the audit, auditors are careful not to violate their obligations. Based on the answers of the respondents the conclusion can be drawn that FAR’s concerns regarding KAM contradicting TCD are justified and that therefore the audit report will be less entity-specific than hoped for by IAABS.

The results of this study also indicate that the new standard will contribute to the reduction of the expectation gap, because the audit report now contains a clearer description of the auditors’ responsibilities. This should help users to understand how the audit has been performed and what the auditors have reviewed in the financial statements. Likewise, the results reveal that the information gap will be reduced, but not to the same degree as the expectation gap, since the auditors are restricted to the extent of specific information they can communicate. With regards to KAM’s impact on the client relationship, the conclusion is reached that it does not affect the relationship to any significant
extent. This is probably because the auditors have a transparent dialog with the companies about KAM, and because the auditors are careful when formulating KAM.

The audit report reflects auditors’ interpretations of the new regulations. Clearly, the extent to which auditors can express themselves is limited due to TCD. An incorrect statement can be sufficient to expose themselves to lawsuits, which can jeopardize their career. Therefore, auditors are more willing to stay within the framework of TCD. After the implementation of KAM auditors seem to be in a position of higher risk, since the new standard requires them to write further about what they have reviewed and why; as a logical consequence they are careful, as they have expressed. Since KAM requires auditors to provide more information in the audit report, it is important that they have better conditions to increase their willingness to expose more information. Accordingly, the possibility of exposing more information should not be limited by TCD to the extent that the auditors fear overstepping the regulation. Rather, a balance should exist between TCD and KAM. For example, this could involve reducing the possibility of being exposed to lawsuits, which is a fear among auditors. This would reduce the fear of breaking TCD, and instead provide users with a more informative and transparent audit report.

**Proposals for further research**

Since most of the respondents raised that the audit report will be less entity-specific than the IAASB had hoped, since auditors read other audit reports, it would be interesting to investigate whether users perceive the audit report as more informative than previously. This is important to investigate because this is the first year that companies receive the new audit report with extended audit statements, which has been implemented for their benefit. One example of how this could be examined is to distribute surveys to users, to establish whether they think that more valuable information has been added to the audit report, or if the vast quantity of information has made the report more difficult to process – as some of the respondents feared.
References


Appendix 1

General questions

- What is your current position in the company?
- How many years of experience do you have of working within the industry?
- What type of clients do you review?

The new audit report

- What are your thoughts on the previous audit report and the purpose it fulfilled in comparison with the new audit report?
- What is your view of an extended audit report?
- What advantages and disadvantages do you see with an extended audit report?
- Do you think there was a need for more information in the audit report?
- Do you think KAM has contributed to greater transparency and knowledge of the audit? If yes/no, why?
- What has been most challenging when framing KAM in the audit report?
- How do you handle the risk areas that have been identified?
- The new audit report requires auditors to write about issues that have previously been shared orally during the Annual General Meeting. What challenges do you experience with this?
- Do you think there is a risk that the new audit report identifies industry-specific risks rather than company-specific risks?
- According to different sources, there is a risk that the expected advantages will disappear since the information in the audit reports could remain standardized. What is your view on this?
- Has the implementation of ISA 701 changed the scope of your work? If yes/no, how?

KAM’s influence on the expectation and information gap

- Do you think it is part of the auditor’s assignment to reduce the expectation and information gaps? If yes, why? If no, why?
- What effect do you think an extended audit report according to ISA 701 could have on the expectation gap?

- Does the auditor have a responsibility to provide an improved information value for users? If yes/no, why?

**KAM’s impact on TCD and the client relationship**

- Do you think that the confidentiality duty has limited the possibility of publishing entity-specific information in the audit report? If yes/no, why?

- How do you manage KAM’s requirement to publish information about the risk and focus areas without violating the confidentiality duty?

- How do you balance the demand of information from stakeholders without breaking the confidentiality duty?

- Which obligation is the most important, and why?

- Do you think that KAM can contradict TCD? If yes/no, why?

- How has the implementation of KAM affected the relationship with your clients?