



# The Effect of Key Audit Matters on Financial Information Quality: The Case of Tunisia

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**Abstract:** This research investigates the impact of Key Audit Matters (KAM) on financial information quality in Tunisian firms. For this reason, we use 52 Tunisian firms for the period 2017-2020. Our GLS and GMM regressions indicate that, in agreement with the agency theory, external auditor has an effective role, as an instrument of monitoring, to prohibit the opportunistic activities of managers. It supervises the manager's behavior by the disclosure of KAM. Hence, it serves as a crucial tool that contributes to improve financial information quality and to decrease information asymmetry. In addition, it is considered as an important mechanism for preserving trust in financial reporting and integrity of financial information. This study is important for potential investors who should assess KAM when evaluating firms. Furthermore, our results will be useful to companies because they provide evidence that the external auditor can effectively reduce managerial opportunistic behavior and enhance information quality. Finally, they could encourage audit regulators to ameliorate the audit standards.

**Keywords:** Key Audit Matters (KAM), Information Quality, Tunisian Firms, Generalized Last Squares

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## 1. Introduction

The audit report is an auditor's opinion written letter which leads firm's financial statements to verify the fair position of their performance and their financial health. Indeed, it is vital for maintaining trust in financial reporting and integrity of financial information [15]. In addition, it grants a reliable signal in constructing and sustaining investors' trust on the transparency and the credibility of such financial information [1].

The audit report plays an important role for investors who use firm's financial statements before making financial decisions, such as: structuring investment portfolios efficiently, allocating funds more effectively, and mitigating the costs of adverse selection that shareholders have to face [11].

In line with the agency theory, external auditor acts as a monitoring mechanism that minimizes managers' opportunistic behavior [12]. Hence, it achieves its accountability in ensuring the credibility and transparency of

corporate disclosure. The principal responsible for expressing an opinion is the external auditor. This opinion should indicate that reasonable assurance has been obtained that the financial statements as a whole are free from errors and material misstatement. Therefore, firms should provide relevant and reliable financial information because this latter is considered as a crucial resource for users.

The auditor puts your opinion in the audit report that is communicated to users of financial statements [7]. However, prior surveys show that stakeholders demand that the audit report should be more informative by providing supplementary information about the revised company.

In this context, on December 2014, the audit standards board (International Auditing and Assurance Standards Board, "IAASB") approved a new International Standard on Auditing ("ISA 701: *Communicating Key Audit Matters in the Independent Auditor's Report*"). The application of this standard begins on December 2016. It requires auditors to supply, in their audit report, key audit matters (KAM). They are selected from KAM communicated to the responsible of the company's governance.

The objective of this recently introduced standard was to enhance the auditor disclosure by stressing on the transparency of the audit procedure. Moreover, it aims to display an idea into complex accounting matters, which may help users interpret the financial statements.

Numerous studies examine the effect of audit opinion nature on information quality [2, 7, 8, 13]. This research differs from existing ones as it focuses on the impact of key audit matters (KAM) on financial information quality in Tunisian firms. Thus, we use in this study 52 Tunisian firms. They are characterized by greater concentrated ownership and the dominance of family investors in listed companies [7].

Our research adds to the accounting literature in different manners. We explore the impact of the disclosure of KAM on the managers' behavior. Yet, the KAM is considered as an important mechanism for preserving trust in financial reporting and integrity of financial information. Indeed, it gives a crucial sign about the reliability of the financial information [1]. Furthermore, the KAM plays an important role for investors who use financial statements before making a financial decision. Finally, we outline that, following the agency theory, external auditor behaves as a monitoring mechanism which help to reduce managers' opportunistic behaviors. Consequently, it achieves its accountability in ensuring the credibility and transparency of disclosure.

The structure of this paper is as follows. Section 2 provides the literature review and hypotheses development. Section 3 describes the research methodology. Section 4 discusses the results and discussions. Section 5 concludes our work.

## 2. Literature Review and Hypotheses Development

The agency theory emphasizes the corporate governance and sheds light on their mechanisms that help to control managerial actions. One important corporate governance device is external auditor that is likely to mitigate managerial opportunistic behavior, reduce agency problems and enhance information quality [12]. Then, it is a crucial means to limit agency problem and information asymmetry.

In fact, shareholders have more confidence in accounting information when it is disclosed by external auditors because it is likely to be more reliable. Hence, they can make decisions based on such information [16].

External auditor is greatly needed to certify the information's credibility to all stakeholders. As a result, investors and managers tend to appoint reputable auditors because such auditors are likely to raise the faithful representation of the information disclosed in financial statements.

One of the tools by which auditors may increase information quality is the key audit matters. These KAM are communicated by auditors in their reports to enable the users, generally investors, to get a good understanding

about the causes beyond the statutory auditors' opinion disclosed in the financial statements. Accordingly, the agency theory considers the KAM as a reliable channel that gives credible and relevant information about the firm's economic reality.

Previous studies indicate that KAM can have an attention-orienting impact, an information influence, or can be a source of sincerity. [4] show that shareholders who obtain a key audit matters' section in the audit report will base their investment decision upon it. Also, they documented that the disclosure of KAM connected to the fair value in the financial statements appeal to nonprofessional shareholders. In addition, the investment decision made by shareholders is more likely to be changed when the audit report provides KAM.

Chinese auditing standards approve the disclosure of key audit matters (KAM) in audit reports for all listed firms since 2017. In this sense, [18] investigate the effect of KAM on financial information. They show that the financial information with a KAM displays greater quality than that without a KAM, leading to a positive correlation between financial information quality and KAM.

[9] Examine the impact of the KAM disclosure on the managers' behavior. They find that managers react to the KAM disclosure by increasing their own disclosure of the matter and that this impact varies directly with the power of the audit committee's oversight. The authors also outline that as auditors raise the level of detail exhibited in its KAM reporting, managers respond with higher disclosures. Finally, when the auditor discloses a detailed KAM, it appears that managers are likely to raise disclosure of quantitative information that would improve the financial statement user's ability to quantify the risk in a critical accounting estimate.

The preceding discussion provides that KAM is effectively associated to financial information quality. Thus, our initial hypothesis is as following:

*H1: Key audit matters affect positively the quality of financial information.*

## 3. Research Design

### 3.1. Firm Sample Selection and Data Source

Our sample includes Tunisian firms listed in the Tunisia Stock Exchange during a four-year period, from 2017 to 2020. The initial sample contains 88 firms. We eliminate financial firms because they have specific features. Also, we remove firms with incomplete data. Consequently, the final sample covers 52 firms over the period 2017-2020. We choose this period because the new standard (ISA 701) is applicable for audits of financial statements from 2016.

### 3.2. Variables

*Financial Information Quality:* Our dependent variable is proxied by Discretionary Accruals (DA) which is a measure of earnings management practices. We estimate the discretionary

accruals as an inverse proxy for financial information quality. Following previous studies on financial information quality,

we use the model of Jones modified [6] to estimate DA. The model is presented as follows:

$$TAit / LTAit-1 = \beta_1 (1 / LTAit-1) + \beta_2 (\Delta REVit - \Delta RECit / LTAit-1) + \beta_3 (PPEit / LTAit-1) + \epsilon it \quad (1)$$

Where:

TAit: Total Accrual of a company; LTAit-1: Lagged Total Asset;

REVit: Revenue,  $\Delta REVit = REVit - REVit-1$ ; RECit: Receivable,  $\Delta RECit = RECit - RECit-1$ ; and PPEit: Property Plan and Equipment.

All variables are scaled by lagged total assets to control firm size, and to decrease the heteroskedasticity. The residual ( $\epsilon it$ ) from this regression is the estimate of Discretionary Accruals (DAit).

*Key Audit Matters (KAM)*: Following [9], KAM is a dummy variable that equals to “1” when the auditor discloses at least one KAM in the audit report, and 0 otherwise.

*Control variables*: We introduce control variables in our model that are commonly used in literature to influence financial information quality [17] and [18]. First, firm size

(Size) is measured as the Neperian logarithm of total assets. Leverage is measured by the ratio of total debts to total assets. Firm performance is proxied by the return on assets (ROA) calculated by the ratio of net income to total assets. Sales growth (Growth) is the ratio of (revenue (t) - revenue (t-1) / revenue (t-1)). Cash flow measures the firm cash flow as the ratio of (Cash flow from operations (t) / Net sales or revenues (t)) \* 100). Finally, we include audit quality using the dummy variable BIG 4 that equals to 1 if the firm is audited by a BIG 4, 0 otherwise.

### 3.3. Model Specifications

This paper aims to test the effect of key audit matters on financial information quality, in the Tunisian context. Thus, we use the model listed below. It is estimated by the Generalized Least Squares (GLS).

$$DAit = \beta_0 + \beta_1 KAMit + \beta_2 Sizeit + \beta_3 Leverageit + \beta_4 ROAit + \beta_5 Growthit + \beta_5 BIG\ 4it + \epsilon it \quad (2)$$

With:

DAit = Discretionary Accruals estimated by the model of Jones modified [6].

KAMit = Key Audit Matter is a dummy variable that equals to “1” when the auditor discloses at least one KAM in the audit report, and 0 otherwise.

Sizeit = Firm Size is the Neperian logarithm of total assets. Leverageit = Leverage Ratio is the ratio of total debts to total

assets.

ROAit = Firm Performance is the ratio of net income to total assets.

Growthit = Firm Growth is the ratio of (revenue (t) - revenue (t-1) / revenue (t-1)).

BIG 4it = External Audit Quality is a dummy variable: takes 1 if firm is audited by a BIG 4, 0 otherwise.

**Table 1.** Descriptive Statistics.

Panel A.					
Variables	Observations	Mean	Std. Dev.	Min	Max
DA	197	0.0440799	0.037386	0.0002213	0.2670367
Size	197	18.51251	1.305627	15.34418	22.04603
Leverage	197	0.338093	0.3871179	0	2.766385
ROA	197	0.0100464	0.220092	-1.403327	1.604
Growth	197	0.0748788	0.3699986	-0.8196538	3.937211
Panel B.					
Dummy variables	Modalities	Frequency			
KAM	0	49 (24.87%)			
	1	148 (75.13%)			
BIG 4	0	121 (61.42%)			
	1	76 (38.58%)			

Table 1 displays the descriptive statistics of our variables. DA = absolute value of discretionary accruals. KAM: key audit matters = 1 if the auditor discloses at least one kAM in the audit report, and 0 otherwise. Size =  $\ln(\text{total assets})$ . Leverage = the ratio of total debts to total assets. ROA = the ratio of net income to total assets. Growth =  $\text{revenue (t) - revenue (t-1) / revenue (t-1)}$ . BIG 4 = 1 if firm is audited by a BIG 4, 0 otherwise.

## 4. Empirical Results and Discussion

### 4.1. Descriptive Statistics

Table 1 reports the descriptive statistics of sample variables. The mean and the median for the absolute value

of discretionary accruals are about 0.044 and 0.037. This means that half of the Tunisian companies present overestimated earnings. Our result is consistent with the one provided by [7] in the Tunisian context. Table 1 also supplies that 75.13 per cent of Tunisian companies exhibit key audit matters in their annual audit reports, and 24.87 per cent of Tunisian firms provide no key audit matters.

This indicates that, most auditors communicate one or more KAM in their reports to respond the preoccupation of information users. Also, this demonstrates that auditor sheds the light on the financial statements issues and help users to understand the firm.

#### 4.2. Correlation Analysis

Table 2 provides the correlation coefficients between the

independent variables. The Pearson correlation matrix emphasizes well that the correlations present values less than “0.8”. Due to this fact, the problem of multicollinearity between the continuous explanatory variables does not exist.

In addition, we use the variance inflation factors (VIFs) to test the presence of multicollinearity among the explanatory variables. Indeed, in all cases, the VIFs show that there is no problem of multicollinearity.

*Table 2. Pearson Correlations Analysis.*

	KAM	Lev	Size	ROA	Growth	BIG 4	VIF
KAM	1.0000						1.07
Lev	0.0754	1.0000					1.37
Size	0.0838	0.1971*	1.0000				1.17
ROA	-0.0791	-0.6774*	0.0158	1.0000			2.01
Growth	0.0151	-0.0881	0.1179	0.3190*	1.0000		1.09
BIG 4	0.1424	0.1278	0.2443*	0.0222	-0.0125	1.0000	1.28

Table 2 points out the Pearson correlations between our variables and the VIF statistics. KAM: key audit matters = 1 if the auditor discloses at least one kAM in the audit report, and 0 otherwise. Size =  $\ln(\text{total assets})$ . Leverage = the ratio of total debts to total assets. ROA = the ratio of net income to total assets. Growth =  $\text{revenue}(t) - \text{revenue}(t-1) / \text{revenue}(t-1)$ . BIG 4 = 1 if firm is audited by a BIG 4, 0 otherwise.

#### 4.3. Regression Analysis

Table 3 out puts the results of our empirical regressions.

It releases a negative and statistically significant relationship between KAM and the discretionary accruals at the 5% level. This gives evidence that the key audit matters disclosed in the auditor's report affect negatively earnings management practices suggesting that higher KAM leads to greater financial information quality.

The results accentuate that KAM serve as a good tool for ameliorating financial information quality and for reducing aggressive financial reporting behavior. For that reason, KAM is considered as a key mechanism of oversight that has a positive impact on the audit reporting process and on the quality of disclosed information. Higher transparency via

KAM raises manager's level of accountability to the information's users, ultimately leading to higher financial information quality. As a result, this finding confirms that the KAM adds value to an audit report.

Taken together, our results demonstrate that, in accordance with agency theory, KAM section can serve as a crucial system for decreasing managerial earnings management activities and for minimizing information asymmetry [10]. Hence, our first hypothesis (H1) is confirmed.

As for control variables, results in table 3 exhibit that firm size (Size) has a positive and significant effect on financial information quality. The same result is observed for firm performance (ROA) and firm debts (Leverage). However, BIG 4 and CashFlow have a negative influence on financial information quality.

*Table 3. Regression Results.*

Dependent variable =DA	Model 2
KAM	-0.003 (0.050)**
Leverage	-0.021 (0.001)***
Size	-0.006 (0.000)***
ROA	-0.036 (0.043)**
Growth	-0.006 (0.073)*
BIG 4	0.003 (0.222)
Constant	0.163 (0.000)***

Table 3 sets out the regression results for a sample of 52 Tunisian listed firms between 2017/2020. DA = absolute value of discretionary accruals estimated by Jones modified model. KAM: key audit matters = 1 if the auditor discloses at least one kAM in the audit report, and 0 otherwise. Size =  $\ln(\text{total assets})$ . Leverage = the ratio of total debts to total assets. ROA = the ratio of net income to total assets. Growth =  $\text{revenue}(t) - \text{revenue}(t-1) / \text{revenue}(t-1)$ . BIG 4 = 1 if firm is audited by a BIG 4, 0 otherwise. The symbols \*, \*\*, and \*\*\* denote statistical significance at the 10%, 5%, and 1% levels, respectively.

#### 4.4. Robustness Checks

To verify the robustness of our results, we perform additional regressions. First, we use the Generalized Method of Moments

(GMM) dynamic panel data to address the endogeneity concern [3]. Table 4 provides that the results remain qualitatively unchanged using the GMM estimation technique.

Table 4. GMM Regressions.

Dependent variable = DA	Model 2
I. DA	0.131 (0.383)
KAM	-0.027 (0.024)**
Leverage	-0.011 (0.061)*
Size	-0.009 (0.001)***
ROA	-0.010 (0.043)**
Growth	-0.000 (0.969)
BIG 4	0.006 (0.220)
Constant	0.242 (0.000)***
F (7, 50)	88.79 (0.000)*** 145
Prob > F Number of observations	50.29/(0.000)***
Sargan test of overid. restrictions: chi2(11)/Prob > chi2	z = 0.59/ Pr > z = 0.558
Arellano-Bond test for AR(1) in first differences	z = . /Pr > z = .
Arellano-Bond test for AR(2) in first differences	

Table 4 releases the regression robustness results for a sample of 52 Tunisian listed firms between 2017/2020. DA = absolute value of discretionary accruals estimated by Jones modified model. KAM: key audit matters = 1 if the auditor discloses at least one kAM in the audit report, and 0 otherwise. Size = ln (total assets). Leverage = the ratio of total debts to total assets. ROA = the ratio of net income to total assets. Growth = revenue (t) - revenue (t-1) / revenue (t-1). BIG 4 = 1 if firm is audited by a BIG 4, 0 otherwise. The symbols \*, \*\*, and \*\*\* denote statistical significance at the 10%, 5%, and 1% levels, respectively.

Second, we choose the number of KAM disclosed in the auditor's report as alternative proxy for our independent variable. The results presented in table 5 show that the number of KAM reported negatively influences discretionary accruals as reported above.

Table 5. Alternative Measure of KAM.

Dependent variable = DA	Model 2
I. DA	0.235 (0.135)
NKAM	-0.007 (0.005)***
Leverage	-0.010 (0.055)*
Size	-0.009 (0.000)***
ROA	-0.011 (0.036)**
Growth	0.001 (0.969)
BIG 4	0.006 (0.882)
Constant	0.224 (0.000)***
F (7, 50) Prob > F Number of observations	124.72 (0.000)*** 145
Sargan test of overid. restrictions: chi2(11)/Prob > chi2	47.52/(0.000)***
Arellano-Bond test for AR (1) in first differences	z = 0.85 Pr > z = 0.394
Arellano-Bond test for AR (2) in first differences	z = . /Pr > z = .

Table 5 provides the regression robustness results for a sample of 52 Tunisian listed firms between 2017/2020. DA = absolute value of discretionary accruals estimated by Jones modified model. NKAM: Number of Key Audit Matters = the number of KAM in the audit report. Size = ln(total assets). Leverage= the ratio of total debts to total assets. ROA = the ratio of net income to total assets. Growth = revenue (t) - revenue (t-1) / revenue (t-1). BIG 4 = 1 if firm is audited by a BIG 4, 0 otherwise. The symbols \*, \*\*, and \*\*\* denote statistical significance at the 10%, 5%, and 1% levels, respectively.

Finally, we use an alternative measure of earnings management and financial reporting quality. We focus on the [14] model. This model is presented as follows:

$$TA_{it} / LTA_{it-1} = \beta_0 (1 / LTA_{it-1}) + \beta_1 (CFO_{it-1} / LTA_{it-1}) + \beta_2 (CFO_{it} / LTA_{it-1}) + \beta_3 (CFO_{it+1} / LTA_{it-1}) + \beta_4 (\Delta REV_{it} / LTA_{it-1}) + \beta_5 (PPE_{it} / LTA_{it-1}) + \epsilon_{it}$$

Where:

TA<sub>it</sub>: Total Accrual;

LTA<sub>it-1</sub>: Lagged Total Asset;

CFO<sub>it-1</sub>: Lagged Cash Flow from Operations; CFO<sub>it</sub>: Cash Flow from Operations;

CFO<sub>it+1</sub>: Future Cash Flow from Operations; REV<sub>it</sub>: Revenue,  $\Delta REV_{it} = REV_{it} - REV_{it-1}$ ; and PPE<sub>it</sub>: Property

Plant and Equipment.

The discretionary accruals are estimated by the residuals of the model.

Table 6 shows the results about the effect of KAM on discretionary accruals using the [14] model and confirm a negative relationship as with our main finding.

Table 6. Alternative Measure of Discretionary Accruals.

Dependent variable = DA	Model 2
I. DA	-0.793 (0.029)**
CAM	-0.082 (0.003)***

Dependent variable = DA	Model 2
Leverage	0.005 (0.595)
Size	-0.026 (0.000)***
ROA	0.020 (0.272)
Growth	-0.029 (0.001)***
BIG 4	0.018 (0.059)*
Constant	0.651 (0.000)***
F (7, 50) Prob > F Number of observations	61.58 (0.000)*** 145
Sargan test of overid. restrictions: chi2(11)/Prob > chi2	13.85/(0.017)**
Arellano-Bond test for AR(1) in first differences	z = 0.85 Pr > z = 0.398
Arellano-Bond test for AR(2) in first differences	z = . /Pr > z = .

Table 6 issues the regression robustness results for a sample of 52 Tunisian listed firms between 2017/2020. DA = absolute value of discretionary accruals estimated by McNichols (2002) model. KAM: key audit matters = 1 if the auditor discloses at least one kAM in the audit report, and 0 otherwise. Size =  $\ln(\text{total assets})$ . Leverage = the ratio of total debts to total assets. ROA = the ratio of net income to total assets. Growth =  $\text{revenue}(t) - \text{revenue}(t-1) / \text{revenue}(t-1)$ . BIG 4 = 1 if firm is audited by a BIG 4, 0 otherwise. The symbols \*, \*\*, and \*\*\* denote statistical significance at the 10%, 5%, and 1% levels, respectively.

## 5. Conclusion

This study focuses on the impact of key audit matters (KAM) on financial information quality (proxy by discretionary accruals). We use 52 Tunisian firms between 2017 and 2020. This period is characterized by the promulgation of the new standard (ISA 701) which emphasizes the obligation of the disclosure of KAM in the audit's report.

Our findings point out that key audit matters disclosed in the auditor's report negatively affect earnings management practices. Consequently, KAM section reduces information asymmetry and increases information quality by improving the credibility of financial statements disclosed by Tunisian firms. Our study supports the agency theory perspective that considers the external auditor as a monitoring mechanism which decreases managers' opportunistic behavior and improves financial information quality.

These results suggest that key audit matters can increase managers' ability to meet investor's objective. This research aims to deepen this idea by providing evidence that KAM is a positive signal of higher credibility and transparency of the auditors because investors can have more confidence in the information, which improve decision making. Accordingly, effective corporate governance which enhances the corporate transparency has the potential to improve financial reporting quality.

Shareholders can take benefit from key audit matters to efficiently structure their investment portfolios. This because auditors raise the level of detail of KAM, managers respond with greater financial information quality. Thus, providing detailed KAM section by auditors, encourage managers to increase the quality of financial information.

In addition, our results are important for potential investors who should assess key audit matters when evaluating firms. Our findings have implications in Tunisia. They can help Tunisian investors, auditors and regulators, who are concerned by improving the supervision of companies and decreasing the opportunities given to managers to engage in earnings management.

The present work can be extended, in future research, by

using other attributes for audit quality [5]. Also, it could be interesting to investigate the influence of KAM on investment decision and dividend payout policy.

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