

Impacts of financial and industry expertise of the audit committee on the readability of key audit matters: New Zealand evidence

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Abstract

Purpose – The purpose of this study is to examine the impact of the audit committee’s financial and industry expertise on the readability of KAMs using New Zealand evidence.

Design/methodology/approach – The sample covers 50 New Zealand listed companies for the financial year 2021. Correlation and regression analyses were conducted to examine possible relationships between the audit committee’s financial and industry expertise and the KAM readability. The Flesch Reading Ease Formula was used to measure the KAM readability.

Findings – Both financial and industry experts on the audit committee are positively associated with the KAM readability, although the overall readability of KAMs is very low.

Research limitations – This research only covered one year and a sample of 50 companies. Other firm and audit committee attributes excluded in this paper may also impact the KAM readability.

Originality/value – The research makes a contribution to prior empirical research on KAM, and evidence of audit committee effectiveness. The study raises a question for the standard setters on how to improve KAM readability.

Keywords – Key audit matters, Audit committees, Industry expertise, Financial expertise

1.0 Introduction

An audit expectation gap has been discussed by standard setters and researchers over time. Concerns are still being raised by regulators of the gap between what users and the public expect of an audit and what auditors are regulated to do (ACCA, 2019). One of the actions taken to reduce the expectation gap was to amend the auditor report. The Public Company Accounting Oversight Board (PCAOB) (PCAOB, 2013) consultations highlighted weakness of the audit report in providing little specific information on the company's financial statements and the auditor's approach. Users requested more information giving insights on the audit and to make the audit report more relevant and useful information. In response regulator introduced a new section, Key Audit Matters (KAMs) in auditor reports.

The United Kingdom (UK) Financial Reporting Council (FRC) required KAMs in audit reports of companies listed on the London Stock Exchange (LSE) from 1st October 2012 (Financial Reporting Council, 2013). Subsequently, the International Auditing and Assurance Standard Board (IAASB) issued International Standard on Auditing (ISA) 701, requiring KAMs as a mandatory part of auditors' reports on or after 15th December 2016. The standard defined KAMs as "those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance" (IAASB, 2016, para. 8). The purpose of the extended audit standard has been to enhance the "communicative value of the auditor's report" and assist intended users with a better understanding of the most significant matters of the financial statements (IAASB, 2016, para. 2). The New Zealand External Reporting Board (NZ XRB) adopted the enhanced audit standard via ISA (NZ) 701 in 2015, and the effective time was the same as ISA 701. In the United States (US), the PCAOB adopted the requirement of Critical Audit Matters (CAM) in the audit report from December 2017 to "make the auditor's report more relevant to investors and other financial statement users" (PCAOB, 2020, para. 3).

The purpose of the audit report is to communicate to investors and other users expressing an opinion on the financial statements, it is important that they are understandable. The ISA 701 was the first attempt by standard-setters to include expanded disclosures in the audit

report. However, it is not immediately clear that the audit report disclosures would improve the communicative value of the audit report. The readability of KAMs could affect the decision usefulness of audit reports and the impact of the enhanced audit report (Smith, 2016).

Empirical research on KAM disclosures has grown since the new audit standard was issued. KAMs research has covered a range of effects of the new audit report in terms of impact on auditor liability (Gimbar et al., 2015), on audit fees, audit report lag and audit quality (Alumulla & Bradbury, 2018; Bedard et al., 2019; Gutierrez et al., 2018; Hay et al., 2021; Li et al., 2019), and the impact on auditor judgement and action (Asbahr & Ruhnke, 2019), Sierra-García et al., 2019; Lennox et al., 2021; Nguyen & Kend, 2021). However, the language employed to explain the KAM has been neglected.

Based on agency theory (Jensen & Meckling, 1976), audit committees are set to protect the interests of the shareholders and are responsible for the engagement of independent auditors and monitoring auditing processes (NZX, 2020). Thus, they should focus on a more readable auditor's report. However, previous literature has focused more on the relationship between the audit committee (AC) composition and the financial reporting and audit quality, and firm performance (e.g., Carcello & Neal, 2000; Chen et al., 2005; Ika, & Ghazali, 2012; Kim et al., 2012 and Ud Din et al., 2021). Few studies have investigated the specific readability of KAMs using AC composition variables as determinants. Only Velte (2018; 2019) examined the association between the AC gender diversity or expertise and KAM readability in the UK. No similar research has been conducted in New Zealand.

The purpose of this study is to examine the impact of AC's financial and industry expertise on the readability of KAMs using New Zealand evidence. The results of the study will be of use to financial and auditing standard setters as part of post implementation evidence of the expanded audit report. The evidence of readability will also be of use to capital market regulators and professional accounting bodies on reducing the audit expectation gap.

To the best of our knowledge, this study was the first one investigating the effect of AC's expertise on the KAM readability in New Zealand.

2.0 Literature Review

2.1 Key Audit Matters

Studies related to KAMs have increased recently. Velte & Issa (2019) literature review and analysis of empirical studies reported that the research has mainly focused on the impact of KAMs on five groups including shareholders, debtholders, external auditors, boards of directors, and other stakeholders. Studies in these areas are summarised as follows.

Studies have been conducted to investigate the effects of KAMs on investors' perceptions. In the United States Rapley et al. (2021) found that nonprofessional investors are less likely to invest when the auditor discloses a CAM (equivalent to a KAM) compared to when the auditor discloses that no CAMs were identified. CAM disclosures have a negative impact on investors' perceptions of the risk of material misstatement and the disclosure credibility of management because a CAM highlights increased complexity and subjectivity. CAM disclosures however, have a positive impact on investor perceptions of audit quality. Similarly, Kipp's (2017) survey of nonprofessional investors found that a detailed description of the CAM improved shareholders' perception about the financial reporting quality compared with a generic description of the CAM. Köhler et al. (2020) found that KAM disclosures have enhanced the communicative value of the auditor's report only among professional investors.

The inclusion of KAMs was found with no material effect on lenders' perceptions of the quality of financial reporting and audit (Booak & Quick, 2016). Loan officers rated KAMs as highly important (Trpeska et al., 2017).

A number of studies considered the effects of reporting KAMs on the audit function. Asbahr and Ruhnke (2019) identified that auditors' sceptical judgments about the reasonableness of a biased accounting estimate were not affected by the KAM disclosures. In terms of the audit function studies focussed on the impact of KAMs on audit quality, efficiency and cost. Bédard et al. (2019) found that the expanded audit report had no impact on audit lag, audit quality, and audit fees in France. Using United Kingdom (UK) data, Gutierrez et al. (2018) also found the expanded report has no impact on audit quality, audit fees and provided little incremental information to investors. Reid et al. (2019) also used UK data and did not find an increase in audit costs but there was a significant improvement in financial reporting

quality through a reduction in absolute abnormal accruals. In New Zealand conflicting results have been reported. Almulla & Bradbury (2022) research indicated that KAMs had no impact on audit fees, audit lag and audit quality. In contrast, Li et al. (2019) find that the enhanced audit report resulted in an improvement in audit quality and a significant increase in audit fees.

The impact of KAMs on the board of directors has also been researched. Some studies found that KAMs led to a reduction in earnings management (Klueber et al., 2018; Gold et al., 2020). However, Cade and Hodge (2014) argued that managers had shared less information with external auditors since implementing KAM disclosures.

2.2 Impacts of audit committee composition and member expertise

Jensen and Meckling (1976, p.308) defined the relationship between management (agents) and shareholders (principals) as an agency relationship, which raised the problem that "agents may not always act in the best interests of the principals". To address this problem, boards of directors were given oversight roles to protect the interests of shareholders, such as monitoring executive management teams and internal control systems. Consequently, the audit committee and other board committees were introduced to delegate some of the oversight responsibilities.

The Sarbanes-Oxley Act (2002) specified the audit committee's duties, including overseeing the management of internal and external auditing processes. Therefore, most previous studies were designed based on the assumption that AC's effectiveness positively influences financial and audit reporting quality. DeZoort et al. (2002) demonstrated that the composition of audit committees is one of the essential drivers of enhancing the effectiveness of audit committees. Given this function, a range of research was conducted to examine the impact of AC composition on the quality of financial and audit reporting. AC independence has been positively associated with financial reporting and audit quality in studies by Kent et al. (2010), Ika & Ghazali (2012), and Kim et al. (2012). Likewise, the diversity of gender and age of AC members have been positively associated with the financial reporting quality (Qi & Tian, 2012; Gul et al., 2013; Abbas, 2020; Ud Din et al., 2021).

Besides defining AC's duties, the Sarbanes-Oxley Act (2002) also required an enhanced disclosure of audit committee financial experts. Similarly, the UK Corporate Governance Code (Financial Reporting Council, 2016, p. 17) prescribed that "at least one member of the audit committee has recent and relevant financial experience. The audit committee as a whole shall have competence relevant to the sector in which the company operates." New Zealand's stock exchange (NZX) also introduced the requirement of an audit committee comprised of at least one member with a financial background via the NZX Listing Rules in 2003 (NZX, 2004). Thereby, the importance of AC's expertise was emphasised by regulating bodies.

As a result, a number of studies were completed to analyse the relationship between the audit committee's expertise and financial or audit reporting quality. Sharma and Kuang (2014) found that financial expertise was associated with a decrease in aggressive earnings management in New Zealand. Lee and Park (2019) found that AC financial experts increased the quality of the management discussion and analysis (MD&A) section in annual reports. Audit committees comprised of accounting, finance, and supervisory experts led to greater financial reporting quality (Kusnadi et al., 2016). Krishnan et al. (2011) identified that AC members with legal backgrounds were likely to provide an extra layer to the monitoring of financial reporting and were associated with higher financial reporting quality. In addition, Baatwah et al. (2013) found that financial and industry expertise enhanced the timeliness of financial reporting. Furthermore, combining industry and financial expertise improved the AC's effectiveness in monitoring the financial reporting process. (Cohen et al., 2014).

A few studies have analysed the relationship between AC composition and the readability of KAMs. The percentage of women on the AC has a positive relationship with the KAM readability (Velte, 2018) because female AC members were more likely to strengthen the relationship between the audit committee and the external auditor during an audit. The financial and industry expertise on AC also identified a positive association with the readability of KAMs (Velte, 2019).

3.0 Research Question

As discussed above, prior studies were conducted on the relationships between AC's expertise and the quality of financial reporting and quality. There has been a lack of research on the effect of AC's expertise on the readability of KAMs.

Only Velte (2019) examined the relationship between the AC's financial and industry expertise and the KAM readability in the UK. To the best of our knowledge, no research has focused on AC's expertise (financial & industry) effects on the KAM readability in New Zealand so far. Prior research has shown that financial and industry expertise on audit committees improves their effectiveness in monitoring in improving the quality of financial reporting and audit quality (Sharma & Kuang, 2014; Kusnadi et al., 2016; Lee & Park, 2019) Based on this prior research we argue that this should lead to more readable KAM disclosures. This leads to the following research question:

Does the financial and industry expertise on audit committees impact the readability of the Key Audit Matters section of the auditor's report for New Zealand listed companies?

The NZX Listing Rules mandated "at least one financial expert on an audit committee" since 2003 (NZX, 2004, p. 10). Previous studies have identified a positive relationship between the AC's financial expertise and the financial reporting and audit quality (Sharma & Kuan, 2014; Lee & Park, 2019). Based on these factors, we assumed that the financial experts on the AC positively influence the monitoring process of audit. Therefore, the following hypothesis was developed:

H₁: The financial expertise of audit committees is positively associated with the readability of the Key Audit Matters section of the auditor's report for New Zealand listed companies.

In some capital markets (e.g., the UK), including industry expertise on audit committees are also compulsory (FRC, 2016). The prior research also showed that the industry expertise improved the effectiveness of AC in monitoring the financial reporting process (Baatwah et al., 2013; Cohen et al., 2014). In line with prior research, we hypothesise that the inclusion of industry experts on AC also enhanced the KAM readability:

H₂: The industry expertise of audit committees is positively associated with the readability of the Key Audit Matters of the auditor's report for New Zealand listed companies.

4.0 Sample and data collection

The sample selection covered the top 50 companies listed on NZX Main Board (NZSX) by the highest market capitalisation for the 2021 financial year. Financial institutions were excluded in line with prior studies due to their different operating and financial structures (Lo et al., 2017; Velte, 2019). Of the 50 firms, 3 firms were financial institutions. One company was excluded due to missing available data (it was listed on NZX from the 2022 FY). The 4 excluded companies were replaced by the next largest companies by market capitalisation to reach a final sample of 50 firms.

The section in the audit report on KAMs was collected from auditor reports of the 50 firms, The readability of KAMs section (*KAM*) in audit reports was analysed using the Flesch reading ease formula (Kincaid et al., 1975; Li, 2008; Velte, 2019):

$$206.835 - 1.015 \times (\text{Total words/Total sentences}) - 84.6 \times (\text{Total syllables/Total words}).$$

The Flesch reading ease score (FRES) has been commonly used by researchers to measure readabilities (Nilipour et al., 2020). The FRES is calculated on a 100-point scale and divided into seven readability levels, from very difficult to read to very easy to read. The higher the score the more readable the text as shown in Table 1 (Kincaid et al., 1975).

[Insert Table 1]

Data on audit committee financial and industry expertise was collected from audit committee members' biographies disclosed in the annual reports and companies' websites. In New Zealand, there is no specific definition of audit committee financial or industry expert so the criteria specified from the Sarbanes-Oxley Act (2002) and the Corporate Governance Code (FRC, 2016), were adopted, as shown in Table 2.

[Insert Table 2]

5.0 Research Model

The following regression model is used to test the association of audit committee finance and industry on the readability of KAMs.

$$KAM_i = \beta_0 + \beta_1 FE_i + \beta_2 IE_i + \beta_3 ACSIZE_i + \beta_4 ACMEET_i + \beta_5 SIZE_i + \beta_6 ROA_i + \beta_7 IND_i + \epsilon_i$$

The readability of KAMs (*KAM*) is the natural logarithm of the Flesch Reading Ease Score and is the dependent variable. The proportions of financial experts (*FE*) and industry experts (*IE*) on the audit committees (*AC*) are the independent variables. Control variables frequently measured in recent KAMs and corporate governance research (Velte, 2018; Velte, 2019; Li et al., 2019) include audit committee attributes: the size of audit committees (*ACSIZE*) measured by the number of AC members, and the number of audit committee meetings (*ACMEET*). Firm size (*SIZE*) is a control for the complexity and is measured as the natural logarithm of total assets. Return on assets (*ROA*) controls for firm performance and is measured as earning before interests and taxation scaled by total assets. *IND* is a dummy variable controlling for companies provide services and those not. Table 3 presents the definition of all variables. Audit firm was not a control variable as all companies in the sample were audited by Big4 auditors.

[Insert Table 3]

6.0 Analysis of results

Descriptive statistics

Table 4 presents the descriptive statistics for all variables. The mean readability of *KAM* was 25.86, representing that, on average, the readability level is very difficult to read (refer to Table 1). The maximum score was 50.10 which is still in the range of difficult to read. The mean result of 25.86 was similar to Velte's (2019) study of 26.5. The low *KAM* score would reflect the technical nature of the information however from an agency perspective the auditor needs to communicate to shareholders and other stakeholders in a way that is easy for them to understand (Smith, 2016).

[Insert Table 4]

The proportion of *FE* on the audit committee averaged 39.5%. This was higher than reported in the UK study of 33.6% (Velte, 2019). Industry experts averaged 23.7% which was relatively low compared to the UK of 38.2% (Velte, 2019). This is most likely to be due to industry expertise not being compulsory on New Zealand.

With regard to the control variables, the mean of *ACSIZE* was 3.8 members, with an average of 4.74 meetings a year. *SIZE* shows mean total assets of \$NZ 375 million. The mean *ROA* is 9.2% and 78% of companies offered services.

Regression

Table 5 shows the Pearson correlation coefficient (*r*) for the dependent, independent and control variables. *FE* was found positively correlated with *KAM* to a weak degree ($r = 0.204$). However, there is a higher correlation between *FE* and *KAM* of $r = 0.431$.

[Insert Table 5]

Because weakly positive correlations were found between the dependent variable (*KAM*) and independent variables (*FE* & *IE*) and the correlation coefficients did not exceed 0.8 (Hair et al., 2009), the multiple linear regression model was conducted (significance level (α) = 0.1), as shown in Table 6. The variance inflation factor (*VIF*) for each independent and control variable was also calculated to test for multicollinearity. The highest *VIF* was 1.1413, which was less than 10. Thus, multicollinearity was unlikely to affect the regression results (Hair et al., 2009).

Table 6 presents the multiple linear regression results. The model adjusted R square is 0.252 and the model is statistically significant. The adjusted R squared compared well with 0.254 reported by Velte (2019). The model shows that both *FE* ($p = 0.018$) and *IE* ($p = 0.002$) are significantly positively associated with *KAM*. None of the control variables are significantly associated with *KAM* except for *SIZE*.

[Insert Table 6]

7.0 Conclusion

The extended audit report was introduced to reduce the audit expectation gap. The disclosure of key audit matters was for auditors to communicate to users the significant issues in the audit and the audit procedures undertaken. As the audit committee has a key oversight role of the financial reporting and audit functions, this study focuses on and impact of the audit committee's financial and industry expertise on the readability of *KAMs*.

The study shows that both industry and financial expertise are significantly associated with KAM readability. This result adds to existing research on the impacts of KAMs and of the effectiveness of audit committees and the importance of areas of expertise of audit committee members. However, the overall level of readability is very low and raises a question for the standard setters on how to improve KAM readability?

The results of the study should be considered with the following limitations. The study has only covered one year and a sample of 50 companies. The study has focused on audit committee financial and industry expertise while other attributes may impact KAM disclosures.

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Table 1 Flesch reading ease score

Flesch Reading Ease Score	Readability Levels
0 – 30	Very difficult to read
30 – 50	Difficult to read
50 – 60	Fairly difficult to read
60 – 70	Plain English
70 – 80	Fairly easy to read
80 – 90	Easy to read
90 - 100	Very easy to read
Source: Velte (2019)	

Table 2 Audit committees’ financial & industry expertise measures

Experts in Audit Committees	Criteria
Financial Experts	<p>Audit committee members meet any one of the following conditions:</p> <ul style="list-style-type: none"> • A qualified accountant, e.g. CA or CPA; or • Other financial professionals with experience in financial and accounting matters, e.g. previously worked as CEO/CFO or in big four firms or professor of finance or accounting (Sarbanes-Oxley Act, 2002).
Industry Experts	<p>Audit committee members meet any one of the following conditions:</p> <ul style="list-style-type: none"> • At least five years prior work experience in the company's operating industry; or • At least ten years of experience in the current company (Corporate Governance Code, 2016).

Table 3 Definition of variables

Variable	Definition
<i>KAM</i>	Natural logarithm of the Flesch Reading Ease Score of the KAM disclosure section in the audit report.
<i>FE</i>	The proportion of financial experts in the audit committee relative to total members (refer to Table 2 for the criteria of financial experts).
<i>IE</i>	The proportion of industry experts in the audit committee relative to total members (refer to Table 2 for the criteria of industry experts).
<i>ACSIZE</i>	Number of audit committee members as reported in annual reports.
<i>ACMEET</i>	Annual audit committee meetings
<i>FSIZE</i>	Natural logarithm of total assets (firm size)
<i>ROA</i>	Return on Assets = EBIT/Total Assets
<i>IND</i>	Dummy variable for 1 = firms providing services and 0 = firms not providing services

Table 4 Descriptive summary (n=50)

Variable	Mean	Median	Max.	Min.	SD
<i>KAM</i>	25.864	25.450	50.100	14.700	7.137
<i>FE</i>	0.395	0.333	1.000	0.200	0.154
<i>IE</i>	0.237	0.250	0.800	0.000	0.237
<i>ACSIZE</i>	3.820	4.000	6.000	3.000	0.850
<i>ACMEET</i>	4.740	4.500	12.000	2.000	1.861
<i>SIZE</i>	3,750,470,868	2,574,733,000	10,792,015,418	191,851,974	3,059,469,767
<i>ROA</i>	0.092	0.068	0.393	-0.056	0.086
<i>IND</i>	0.780	1.000	1.000	0.000	0.418

Table 5 Pearson correlation coefficient (n=50)

	<i>KAM</i>	<i>FE</i>	<i>IE</i>	<i>ACSIZE</i>	<i>ACMEET</i>	<i>SIZE</i>	<i>ROA</i>	<i>IND</i>
<i>KAM</i>	1	-	-	-	-	-	-	-
<i>FE</i>	0.204	1	-	-	-	-	-	-
<i>IE</i>	0.431**	-0.074	1	-	-	-	-	-
<i>ACSIZE</i>	0.087	-0.070	-0.021	1	-	-	-	-
<i>ACMEET</i>	-0.153	0.136	-0.185	0.021	1	-	-	-
<i>SIZE</i>	-0.196	0.187	-0.139	0.185	-0.226	1	-	-
<i>ROA</i>	0.117	-0.214	0.328**	-0.066	-0.030	-0.364**	1	-
<i>IND</i>	-0.004	0.035	0.261**	0.059	-0.154	0.053	-0.145	1

** significant at 5% level.

Table 4 Multiple linear regression analysis (n=50)

	Coefficients	p-value
Intercept	2.056	0.00
<i>FE</i>	0.247	0.018**
<i>IE</i>	0.224	0.002***
<i>ACSIZE</i>	0.025	0.158
<i>ACMEET</i>	-0.014	0.117
<i>SIZE</i>	-0.084	0.042**
<i>ROA</i>	-0.126	0.531
<i>IND</i>	-0.049	0.198
<i>R² (adj.)</i>	0.252	
<i>F stat.</i>	3.359	
Significance Level (α)	$\alpha = 0.05$	
Observations	50	

*** Significant at 1% level, ** significant at 5% level.