

AFAANZ Grant 2017-2018 Report

(1) Name, Position, Contact Details for each applicant

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(2) Project Title

Key audit matter (KAM) disclosure quality: Factors affecting audit committee members' responsiveness and independence when negotiating with auditors

(3) Updated Project Summary (500 words) including any variations between the project undertaken and the original application

Our project explores whether audit committee (AC) members react differently to draft Key audit matters (KAM) depending on whether it relates to a matter disclosed in the financial statements, i.e., matching KAM or to a matter not disclosed in the financial statements, i.e., mismatching KAM. We examine how matching versus mismatching KAM affect AC member behavior in a unique setting: where regulatory financial statement surveillance salience is present versus absent. We conducted a 2 x 2 between-subjects experimental design in July and August 2018; where the independent variables manipulated are whether a KAM matched with a note to the financial statements (yes vs. no) and regulatory surveillance program (yes vs. no). 84 director members have participated in this experiment. Consistent with our predictions, we find that AC members focus more of their meeting on questioning the auditor, asking them more probing questions, when KAM mismatch note disclosure and when alerted to the regulator's financial reporting surveillance program.

Our project research questions and method are generally consistent with the original application. We have changed one variable of interest from AC members compensation incentives to ASIC regulatory financial statement surveillance so that our research context fits

into Australian regulatory environment and more aligned with our theoretical framework.

(4) Funds Granted

\$5,000

(5) Detailed Report on Expenditure of Funds against Budget Items, with variations explained

We worked with Qualtrics in recruiting directors from Australian public listed companies. We have made a payment of \$4,000 to Qualtrics (\$50 x 80 participants).

We have recruited a research assistant to analyse the open-ended questions and run analyses. We have made a payment of \$1,000 to a research assistant (\$45 x approximate 22 hours).

The above expenditures of funds are consistent with our proposed budget items and within our total budget requested \$9,750.

(6) Outcomes, for example, working papers, presentations and publications (give full details, including abstracts)

A working paper has been produced- “Audit Committee Response to Key Audit Matters (KAM) and (Mis)Matching Note Disclosures”. We plan to present this paper in conferences and then submit this paper to a journal in 2019.

Abstracts:

Key Audit Matters (KAM) are matters considered most significant during an audit communicated to an audit committee (AC). Regulators have advocated that KAM reporting should not reduce the frankness of communications between ACs and auditors or diminish the oversight role of ACs (IAASB 2013; PCAOB 2016; CAQ 2018). Our study examines AC members’ response to draft KAM tabled by auditors at an AC meeting. Drawing on psychology research on cognitive effect we examine whether AC members react differently when a draft KAM relates to a matter disclosed in the financial statements (match) or not (mismatch), and whether or not they are alerted to regulatory financial statement surveillance on the accounting area addressed in the KAM. Consistent with our predictions, we find that when draft a KAM does not relate to a matter disclosed in the financial statements and when alerted to regulatory financial statement surveillance, AC members are more vigilant as reflected in them asking the auditors more probing questions about the KAM, and focusing more of their meeting discussing the KAM. In this situation, AC members are also more cautious as they perceive greater litigation risk and provide less support for retaining the wording used in the draft KAM. This behavior suggests that there are circumstances that work against the intent of the auditing standard (ISA 701/AS 3101) of encouraging communication about draft KAM to enhance disclosure quality.

(7) Future Intentions for this Project (give full details)

a. Conference submissions

We will submit the working paper to AFAANZ conference, ANCAAR, and AAA annual meeting.

b. Journal submissions

We plan to submit the paper to *Accounting, Organizations and Society* or *European Accounting Review*.

c. Grant applications

None.

d. Projects

None.

(8) Summary of Outcomes and Benefits

Our study makes important contributions to the literature by providing insights into how AC members react to draft KAM and a financial statement regulatory surveillance program. We identify potential unintended consequences associated with KAM reporting and a regulatory surveillance program in which AC members perceive greater litigation risk and provide less support for retaining the wording used in the draft KAM. Auditors may respond to this behavior by including boilerplate KAM in the auditor report, in an effort to satisfy members of the AC. Such KAM lack meaningful information. Our study should be of interests to regulators, auditors, and AC members given the recent regulatory and standard-setting agenda designed to increase the communicative value of audit reports.