



Key Audit Matters: Influences and Relevance for Stakeholders. A Review of the Academic Literature

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Abstract: Following the financial crisis, standard-setters proposed multiple methods to improve the auditor's report quality in order to also increase the financial stability. Thus, the audit report was expanded to include an additional section for the disclosure of the Key Audit Matters. The paper aims to provide a review of 24 academic research papers by assessing three streams of information in respect to the perception of the stakeholders regarding KAMs communication. The paper's findings reveal that there are still debated opinions in terms of KAMs utility. The first set of results showed that due to this expansion of the auditor's report an increase in the quality of the financial reporting was noted and the user's perceived reliability was improved, resulting also in a decrease of the expectation gap. The second stream of research papers analysed revealed that the audit fee increased and so did the auditor's and implicitly the litigation risk and despite the purpose of ISA 701, the transparency level did not increase. Finally, the last set of papers addressed neutral opinions, showing that there is still no sufficient market reaction to assess the utility of KAMs.

Keywords: Audit Report; Key Audit Matters; Stakeholders; ISA 701

JEL Classification: M41; M42

1. Introduction

After the last economic downturn represented by the financial crisis from 2008-2009, the users of the financial statements put a general blame and harshly criticized not only the public interest entities commonly known as PIE but also the financial reporting framework and the report provided by external auditor companies due to the lack of sufficient and clear information about the actual risks of the audited entity.

The auditor's report is the primary mean of communication between auditors and financial statement users (PCAOB, 2017). Due to the increased level of standardization, the audit report is perceived as not being sufficiently informative and transparent (Church, et al., 2008; Vanstraelen, et al., 2012). Moreover, prior research also highlights the existence of an expectation gap between the stakeholders and the auditors and implicitly an information asymmetry (Church, et al., 2008; (Guiral-Contreras, et al., 2007); Vanstraelen, et al., 2012). This information gap is perceived "as the difference between the

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information users need to make informed decisions and the information that is publicly made available to them” (Vanstraelen, et al., 2012).

There were concerns raised also in the prior periods in various academic research papers that brought into the stakeholders’ attention the need for improvement particularly addressing this expectation and information gap. In this sense, Vanstraelen, et al. (2012) concluded that users “are interested in additional disclosures on audit findings such as key areas of risks”. Gray, et al. (2011) stated that “it is not clear to users, preparers, and auditors what the auditor's report is intended to communicate” arguing eventually that significant changes must be made in the auditor’s report to reduce these misperceptions.

These disputes and research findings have sparked a slew of initiatives around the world to improve the auditor's report's communication value. In response to stakeholder concerns, the International Auditing and Assurance Standards Board (IAASB) adopted International Standard on Auditing (ISA) 701 in an attempt to close the information gap and asymmetry between users of financial statements and auditors, as well as improve transparency, improve audit quality, and make audit reports more relevant to their users.

As a result, the audit report was modified, and the auditor now has a new mission: to identify key audit matters (KAMs) and communicate those that, in the auditor's professional judgement, were most important in auditing the current period's financial statements by summarizing them in the auditor's report.

In this paper, a review of the academic research is conducted to examine the impact of this new requirement on the stakeholders. In order to do so, the paper examines three streams of academic research papers. The goal of ISA 701 is to increase communication with both users and regulators, to continuously improve audit report quality and narrow the gap between expectations. Thus, the first stream is represented by papers that examine the added value brought by the requirement of communicating KAMs in the independent auditor’s report.

Marques, et al., (2019) pointed out that, since the implementation of ISA 701, audit procedures have become more formalized, with additional documentation of the work performed and the rationale behind the areas that require professional judgment, and more audit procedures have been performed, in order to reduce audit risk. Thus, the second stream is focused on assessing the negative reactions of the stakeholders concerning the usefulness of this standard. Daugherty, et al. (2020) mentioned that stakeholders question if the disclosure of KAMs “adds enough if any, value to justify its costs” and Christofferson & Gronberg (2018) suggested that the question of whether the initial purpose of ISA 701 is achieved remains, for now, unanswered, therefore, the third stream is emphasising the neutral and/or doubtful opinions.

The paper aims to provide a review of the available literature as well as a summary of the findings and implications of 24 studies. Considering the newness of the topic, no paper was excluded due to time frame considerations, the research includes academic articles and conference proceedings published until 2020.

The study intends to contribute to the development of knowledge as follows. First, conducting a review of the academic papers focusing on the reactions of the stakeholders in respect to KAMs and their evolution from issuance to the present context. Second, auditors could also benefit from this study, by observing how the disclosed matters affect other stakeholders, an aspect that can be perhaps

used to improve the quality of the audit report and channel additional effort towards further diminishing the expectation gap between auditors and the users of their reports. Moreover, the study intends to consolidate all the debated opinions on the additional value that KAMs bring to stakeholders and to focus on identifying exactly the benefits of the new version of the audit report, following the implementation of ISA 701.

2. KAM Regulations: Background Information

One of the most significant modifications to the audit reporting model in the last 90 years has been the introduction of KAMs (Coram & Wang, 2020). It all began in May 2011 when the IAASB released a consultation paper which addressed methods to improve the auditor's report, particularly due to the need for additional knowledge expressed by users of the auditor's report, but also to decrease the expectation and information gap that occurred in time (IAASB, 2011).

Another paper was later issued by IAASB in 2013 entitled "Proposed New and Revised International Standards on Auditing, featuring a new standard: the ISA 701: Communicating Key Audit Matters in the Independent Auditor's Report (IAASB, 2013). The Key Audit Matters are defined as "those matters that, in the auditor's professional judgement, were of most significance in the audit of the financial statements" (IAASB, 2013). The final version of the new and revised ISAs that also included the requirement for public entities to disclose KAMs in their auditor's report was released in January 2015 (IAASB 2015a, ISA 701).

The auditors shall consider several factors when determining KAM:

- (1) areas where the risk of material misstatement is higher, or where significant risks have been identified in line with ISA 315;
- (2) extensive auditor judgements in areas of the financial statements that required significant management judgment, such as accounting estimations with high estimation uncertainty;
- (3) the impact of important events or transactions that arose during the period on the audit;
- (4) whether the internal control system contains flaws concerning the matter investigated;
- (5) whether difficult were encountered when gathering sufficient and relevant audit evidence for the matter investigated; (IAASB 2013, ISA 701: p. 11)

Each KAM shall be described in the auditor's report by taking into account the following aspects:

- (1) the rationale for considering the particular matter strongly significant in the audit;
- (2) methods employed to address the particular matter;
- (3) a reference to the financial statements' relevant disclosures; (ISA 701.13)

This standard, namely ISA 701 applies to audits of listed companies' financial statements for periods ending on or after 15 December 2016. However, in June 2013, the Financial Reporting Council (FRC) in the United Kingdom amended its reporting criteria to improve the transparency of the auditor's report, and these requirements went into effect earlier than in other European countries, on October 1, 2012, for audits of financial statements for periods beginning on or after that date.

Correspondingly, the PCAOB implemented the requirement for disclosing Critical Audit Matters (CAM) in the auditor's report, which is applicable for audits for financial years ending on or after 30

June 2019 for large accelerated filers, and for periods ending on or after 15 December 2020 for the rest of the public listed entities (PCAOB, 2017).

CAMs similarly to KAMs are “matters arising from the audit of financial statements that require to be communicated to the audit committee and refer to auditing accounts or disclosures that are material to the financial statements, and involve especially challenging, subjective or complex auditor judgement” (Jermakovicz, et al., 2018).

Despite the slightly different terminology, the ideas brought by both standards are quite similar, having a common end goal and providing a general guideline for CAM/KAM communication. Jermakovicz, et al. (2018) argued that “CAMs disclosures should be informative and reflect differences in the auditors’ experiences and competencies, whereas, on the other side, a KAM should be specific to the entity and implies significant documentation in order to provide useful and meaningful information to users”.

It's also worth mentioning that under both standards, at least one KAM/CAM is supposed to be disclosed; however, there is no mandated limit, and there may be instances when no KAM/CAM was found; in such cases, the auditor must issue a note in the audit report in this respect (Jermakovicz, et al., 2018).

All these changes were done however to increase the audit report transparency (Li, et al., 2019), and limit the expectation gap (Sirois, et al., 2018). This gap is referred to as “the difference between the information user’s desire and what is available to him/her through the entity’s disclosures and the auditor’s report” (Knechel, et al., 2016).

3. Methodology

The purpose of this literature study is to critically examine relevant literature in the field in order to identify the impact of the disclosure of audit matters in the audit report on the stakeholders. The literature search was performed on the Web of Science database, providing an initial result of 52 papers, both academic articles and conference proceeding papers, out of which only 24 articles were considered relevant for the aim of this research. The sample consists of articles published until 2020; no exclusion of the articles was done based on the time frame since the subject is still new and ongoing research is conducted on it.

The quantitative analysis of the papers was performed using a software solution, namely VOSviewer which facilitates the visualisation of the results in a compact manner. The qualitative analysis was performed manually, the papers were segregated into three main categories as follow:

- (1) papers that examine the additional value brought by the requirement of communicating KAMs in the independent auditor’s report;
- (2) negative reactions of the stakeholders regarding the usefulness of ISA 701;
- (3) papers that present neutral and/or doubtful opinions regarding the usefulness of ISA 701;

The author synthesized the relevant information after adequately separating the articles by categorizing the findings of each publication and combining comparable results into relevant categories.

4. Discussions and Further Research Paths

The studies analysed were segregated into three main categories, as described in the methodology section. The first set of findings refers to the additional value brought to the stakeholders which have been organized in nine subcategories, summarized in Table 1 below.

Table 1. Findings Related to the Communication of KAMs and the Added Value for Stakeholders

| Findings | Reference |
|--|--|
| Positive effect on the audit profession - reduce auditor liability | (Cordos & Fulop, 2014) (Pratoomsuwan & Yolrabil, 2020) |
| Increase financial reporting quality | (Gold, et al., 2020) |
| Increase investors' perceived reliability of reported information | (Hoang & Phang, 2020) |
| Decrease the expectation gap | (Iwanowicz & Iwanowicz, 2019) |
| Increase value of audit report and/or audit procedures performed | (Filipovic, et al., 2019) (Li, et al., 2019) (Kitiwong & Sarapaivanich, 2020) (Moroney, et al., 2020) |
| Increase interest in the audit report | (Sneller, et al., 2017) (Tiron-Tudor, et al., 2018) (Trpeska, et al., 2017) |

Source: Authors' projection

The purpose of this standard was initially intended to diminish the expectation gap between the auditors and the users of the financial statements and, implicitly, the audit report. Pratoomsuwan and Yolrabil (2020) argue for the good implications of KAMs disclosure regarding the auditors: “KAM disclosures reduce auditor liability only in cases of fraud and not in cases of errors”. The auditors “evaluate their risk highly and carry out audits more conservatively in order to reduce the risk” (In et al., 2020) as the liability of the auditor and, implicitly, the litigation risk increase. Additionally, auditors are “putting more effort into their audits and audits are being performed thoroughly after the implementation of KAMs” (Kitiwong and Sarapaivanich, 2020). Another key category of stakeholders is the users of the audit report. KAMs are more likely and have the purpose of increasing the information quality and utility in the auditor’s opinion, to properly draw the users’ attention to the risks to which the businesses are exposed, so the stakeholders will get a clear picture of the main critical accounting topics in light of the current economic environment and can make more informed decisions and realistic investment intentions.

Moroney, et al. (2020) demonstrate that the inclusion of the KAMs paragraph in the audit report improves the perceived value and offers greater credibility only when issued by a Non-Big-Four audit company. When a Big-Four firm conducts the audit, perceived value and credibility are high whether KAMs are included or not (Moroney et al., 2020). Because Big Four audit companies are perceived as being more trustworthy and offering highly ranked and professional audit services, the additional value is sensed more clearly in the Non-Big Four companies’ audit reports. Sirois, et al. (2017) suggest that particularly due to the high level of KAM specificity, users have a better understanding of the disclosures. On the same note, Hoang and Phang (2020) suggest that “disclosures of KAMs increase investors' perceived reliability of reported information”.

Additionally, depending on the type of disclosed KAM, users can gather a better understanding of the company, especially respecting IT-related key audit matters that offer useful information for investors,

suggesting that “auditors may need to pay more attention to high-risk areas such as cyber security” (Sneller et al., 2017).

On the quality of the financial reporting, Gold, et al. (2020) demonstrate “that the presence of KAMs in the audit report leads to less-aggressive financial reporting behaviour and, hence, to an improvement of financial reporting quality”; “the presence of KAMs might lead managers to exert more effort when thinking about their judgment and decision choice” (Gold, et al., 2020).

In a close relationship with second is the fifth subcategory, increased value of audit report and/or audit procedures performed. As Li, et al. (2019) argue, KAMs reporting is associated with increased quality of the audit report, and “the revisions to the audit reporting standards have achieved their intended benefit of increased audit quality”. In line with the previously mentioned aspects, Kitiwong and Sarapaivanich (2020) found that “KAMs disclosure improved audit quality because of auditors putting more effort into their audits and audits being performed thoroughly after the implementation of KAMs”. Iwanowicz and Iwanowicz (2019) emphasise the concept of an expectation gap, representing the difference between what audit-report users expect to find out and what the auditors consider their obligation to disclose. ISA 701 is intended “to enhance the independent auditor’s reporting by making it more informative and insightful, and therefore more valuable to investors and other users of the financial statements” (Iwanowicz & Iwanowicz, 2019). Overall, the authors conclude that ‘implementation of ISA 701 and materiality disclosure limited the audit expectation gap’ (Iwanowicz & Iwanowicz, 2019). Overall, most of the studies suggest in one way or another that the quality of the audit report increased, and in the preliminary stage after the implementation of ISA 701, ‘the respondents agree with the new audit report structure and the inclusion of the key audit matters section in the audit report’, (Tiron-Tudor et al., 2018). Also, according to Iwanowicz and Iwanowicz (2019), the implementation of ISA 701 decreased the expectation gap.

The second set of results summarized below in Tabel 2 are focused on the negative reactions of the stakeholders regarding the usefulness of ISA 701 and implicitly on the utility of communicating the KAMs.

Table 2. Findings related to the communication of KAMs and negative influence on the stakeholders

| Findings | Reference |
|---|---------------------------|
| Increase the expectation gap and scepticism level of stakeholders | (Coram & Wang, 2020) |
| Increase of the audit fees, but without adversely impacting the audit quality. | (Daugherty, et al., 2020) |
| The audit procedures are performed in a more conservatively manner | (In, et al., 2020) |
| Increase of the evaluation of the audit risk | (In, et al., 2020) |
| Increase of liability and risk of litigations for the auditors | (In, et al., 2020) |
| Impact on non-professional investors that encounter difficulties with processing the information conveyed with KAM. | (Kohler et al., 2020) |
| Impact on users as the transparency level did not increase | (Segal, 2019) |
| Impact on users because KAMs have attention directing impact, therefore users devote less attention to the remaining parts of the financial statements if KAMs are reported | (Sirois, et al., 2018) |

Source: Authors' projection

Coram & Wang (2020) conducted an experimental research to investigate how the disclosure of Key Audit Matters affect users' perceptions. The study's findings revealed that the expectation gap has actually increased "when the audit report includes a KAM that follows a precise accounting standard, suggesting some potential unintended consequences of this reporting change". In line with this idea, Segal (2019) argued that "transparency of the audit report had not improved and may have weakened because of the widening auditor expectation gap and the public perceptions of the role of the auditor" concluding that "audit report transparency has not been achieved".

Further on, as far as the audit fees are concerned, (Daugherty, et al., 2020) mentioned that the requirement of communicating the Critical Audit Matters increased the audit fees, but without adversely impacting audit quality. Segal (2019) on the other side highlighted "the new risks auditors face, ranging from the increased threat of litigation, due to highlighting focus areas to a largely uninformed user body, to financial risks caused by higher fees without a proportionate increase in audit fee recoverability".

As far as the auditors' risks are concerned, in, et al. (2020) revealed that the risk of litigation increased due to the introduction of key audit matters and auditors perform auditing work "more conservatively to lower the risk of litigation". This litigation risk is part of the overall audit risk, which consequently is increasing too due to the requirement imposed by ISA 701. When referring to the impact of the KAM paragraph on the users, Koehler, et al. (2020) mentioned that "negative tendencies of KAMs might also fail in effectively conveying the messages intended by the auditor", thus, it is the auditor's role to pay additional attention to the phrasing of KAMs because "signal sent to the financial statements users might differ from the auditors' original intent" (Koehler, et al., 2020). Sirois, et al. (2018) argued that KAMs have an attention directing impact, and for this reason, users when confronted with an auditor's report containing many KAMs, users "devote less attention to the remaining parts of the financial statements" (Sirois, et al., 2018).

The last set of results presents neutral and/or doubtful opinions regarding the usefulness of ISA 701. There is still an open question whether the intended purpose of this standard, namely to increase the transparency of the audit report and decrease the expectation gap between users and auditors was achieved. In this sense, Bedard, et al. (2019) concluded that since the expansion of the audit report "no significant market reaction to their disclosure and no significant effect on audit report lag, audit quality, and audit fee" was noted. In line with this idea, Boolaky & Quick (2016) stated that their study could not demonstrate "a material effect of expanding the audit report to include the materiality level or KAM" and also, that this additional requirement of including a KAM paragraph in the audit report is "not necessarily perceived as useful by stakeholders".

In short, there are relevant number of debates being conducted over this topic, and as a result, there are no unanimous opinions on the overall benefits provided by the implementation of this standard.

5. Conclusion

The IAASB recently developed a distinctive part in the auditor's report to communicate the Key Audit Matters, required by International Standard on Auditing ISA 701. The purpose of this standard is to decrease the expectation gap, which was partially created also due to the high level of standardization of the auditor's report and the language used. In this respect, Gray, et al. (2011) mentioned that "it is

not clear to users, preparers, and auditors what the auditor's report is intended to communicate” and that under these circumstances, changes need to be made concerning the auditor's report.

In order to investigate the perception of the stakeholders in respect to the disclosure of KAMs, a review of the academic literature was conducted, taking into account three streams of research papers. The first set of results revealed that an additional value was brought by the implementation of this new standard. The disclosure of KAMs is from some researchers' point of view beneficial as it reduces the auditor's liability (Pratoomsuwan & Yolrabil, 2020).

Moreover, an increase in the quality of the financial reporting was noted (Gold, et al., 2020) and the user's perceived reliability was improved (Hoang & Phang, 2020). Thus, it is considered that a certain decrease of the expectation gap was obtained through the implementation of the requirements imposed by ISA 701 (Iwanowicz & Iwanowicz, 2019). Moreover, the value of the auditor's report increased, together with the quality of the procedures performed, (Filipovic, et al., 2019; Li, et al., 2019; Kitiwong & Sarapaivanich, 2020; Moroney, et al., 2020) fact that perhaps resulted in a higher interest in information communicated in the auditor's report (Sneller, et al., 2017; Tiron-Tudor, et al., 2018; Trpeska, et al., 2017).

The second set of results was focused more on the negative side of ISA 701 implementation. The paper's results show that not only does this standard fail to decrease the expectation gap, but also it seems that the KAM's communication leads to an additional increase in this gap (Coram & Wang, 2020). Moreover, even though the audit fee increased due to the additional work that has to be conducted by the auditors, it appears that no actual impact was noted in terms of audit quality (Daugherty, et al., 2020), but it is actually performed in a more conservatively manner (In, et al., 2020). An opposite opinion regarding the auditor's risk mentioned in the prior section is emphasised by In, et al. (2020), who mentioned that audit risk and implicitly the litigation risk has increased. As far as the investors are concerned, Koehler, et al. (2020) mentioned that they might encounter difficulties with “processing the information conveyed with KAM”. On the same note, Segal (2019) also pointed out that despite the purpose of ISA 701, the transparency level did not increase.

Finally, the last set of results that analysed the neutral opinions showed that no significant market reaction was yet observed regarding the disclosure of KAMs (Bedard, et al., 2019). Also, according to Boolaky & Quick (2016) this version of the expanded auditor's report is not perceived as useful by the stakeholders and no material effect was noted since the implementation of ISA 701.

This research brings its contribution to the currently existing auditor reporting literature in multiple ways. Firstly, First, the paper analyzes the reaction of multiple stakeholders to the requirement of communicating KAMs, by assessing three streams of academic research papers. Second, due to the limited time frame since the implementation of this standard and the present moment, there is still a literature gap that this paper is addressing, but it also comes as a limitation because there is yet not a sufficient number of studies on this topic that would lead to the identification of more ample results. Finally, the paper's findings are useful for standard setters and auditors because they emphasize the significance of carefully assessing how different types of users understand the KAM section's message.

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