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Audit Committee Effectiveness and Key Audit Matters

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ABSTRACT

Key audit matters (KAMs) are important for financial statement users as they provide clarity and in-depth understanding of financial statement audits. Empirical research on KAMs remains at an early stage particularly in Malaysia. Therefore, the aim of this study is to analyse the disclosure practises of KAMs and to investigate the effects of audit committee effectiveness on KAMs. The study sample consists of the top 100 FTSE index companies in 2016, the first year of implementation of mandatory KAM disclosure under the International Standard of Auditing 701 (ISA 701). Findings show that the majority of sample companies reported two KAMs, mainly about 'revenue recognition' and 'impairment of goodwill and intangible assets'. Results indicate that independent, financial experts and the number of audit committee meetings have a negative relationship with the number of KAMs. However, only companies that have frequent audit committee meetings are able to reduce the number of KAMs. Results provide support on the role of audit committee effectiveness to reduce agency problem between manager and shareholders. Additionally, results provide important policy implications whether imposing unnecessarily high criteria of audit committee members can contribute towards an informative auditor's report.

Keywords: Key audit matters; audit committee effectiveness; corporate governance; enhanced audit report.

Introduction

A series of financial crises among big corporations worldwide such as Enron, WorldCom and Lehman Brothers raised a question about the value of auditing and the role of auditors, particularly the quality of auditors' report. Significant legislative reforms have been introduced to restore market confidence and improve the credibility of the audit service and auditor report. For example, in 2009, the International Auditing and Assurance Standards Board (IAASB) revised the section on the structure and quality of the audit in the International Standards for Auditing (ISA). Subsequently, IAASB issued the new standard, *ISA 701: Communicating Key Audit Matters in the Independent Auditor's Report*. This standard required auditors to report key audit matters (KAMs) as one of the main components to be disclosed in the auditor report. The IAASB defines KAMs in the ISA 701 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'

(ISA 701: Para 8)

Auditors may consider a variety of factors when deciding whether a particular audit issue can be considered a KAM. Firstly, the issue should come from the problems that have been raised with those charged with governance. The auditor may decide whether the issues pose significant risks, require considerable auditor judgement, cause difficulty in auditing and obtaining audit evidence or whether the item is related to deficiencies in internal control.

Following a recommendation from the Malaysian Institute of Accountants (MIA), the new ISA 701 standard was implemented for audits of Malaysian public listed companies' financial statements for periods ending on or after 15 December 2016. The introduction of ISA 701 is expected to provide relevant and useful information to the capital market, minimise uncertainty regarding company performance and encourage understanding of financial statements (Securities Commission Malaysia 2018). Dr. Nurmazilah Mahzan, the Chief Executive Officer of MIA said, the presence of KAMs in auditors' report enables investors to better understand financial statements and could give early warning about the risk of triggering PN17 or GN3 status, especially in a situation where KAMs reveal information about going concerns or fraud issues (Supriya Surendran 2017). The disclosure of KAMs makes auditors' report transparent and informative, thus reducing information asymmetry and improving the quality of financial reporting and audit (Fuller 2015; Velte & Issa 2019).

Since the inception of KAMs, an empirical question has been raised: what types of KAMs are reported in auditors' report and what are the key issues identified in KAMs? The UK Financial Reporting Council (FRC) found that, on average, UK companies had three to four KAMs in the first year of the implementation of ISA 701. Oil and gas companies announced an excessive number of KAMs with an average of seven KAMs during the first year due to economic uncertainty in the sector. The most common issues reported in KAMs across industries are impairment of goodwill, taxes, forecasting, revenue accounting, provision and special transactions such as acquisition and disposal (ACCA 2018).

In Singapore, companies reported an average of two KAMs, and the most common topics are related to impairment of receivables, valuation of inventories, revenue recognition and impairment of goodwill and intangible assets (ISCA 2017). In Malaysia, a study conducted by Securities Commission Malaysia (2018) on 190 companies listed on Bursa Malaysia during the first year of KAMs implementation found that the average number of KAMs reported is equal to that in Singapore. Moreover, the issues that auditors judged to be most significant are revenue recognition, impairment of receivables, goodwill and intangible assets (Securities Commission Malaysia 2018). Further study needs to be carried out to acquire in-depth understanding of KAMs and factors that influence their reporting.

As the audit committee is responsible for overseeing the audit process and issues related to the preparation of financial statements and deals directly with external auditors, committee characteristics may have an effect on KAMs. Past studies show that audit committees' characteristics (gender and financial expertise) are associated with the readability of KAMs (Velte; 2018, 2019). Readability is measured by an index[1] that gauges the understanding of information reported as KAMs. However, these studies did not involve a thorough analysis of the impact of other important audit committee characteristics towards KAMs. Therefore, further study should be conducted to understand whether certain important audit committee characteristics can influence the disclosure of KAMs. Specifically, this study examined whether audit committee effectiveness, which encompasses audit committee independence, audit committee financial expertise and the number of audit committee meeting, can have an effect on the disclosure of KAMs.

The sample for the study consists of top 100 companies listed in Bursa Malaysia in 2016, the first year of ISA 701's mandatory implementation. The findings show that the majority of sample companies reported two KAMs, mainly about 'revenue recognition' and 'impairment of goodwill and intangible assets'. Additionally, the number of meetings held by audit committees is associated negatively with the disclosure of KAMs. Two other audit committee characteristics, audit committee independence and audit committee expertise, are proven not to influence the disclosure. The results provide support on the role of audit committee effectiveness to reduce agency problem between manager and shareholders. The results also provide an important policy implication whether imposing unnecessarily high criteria of audit committee members can contribute towards an informative auditor's report.

The content of this paper is arranged as follows. The following section discusses the literature on KAMs, the association between audit committee and KAMs and the development of the main hypotheses. It is followed by the research design, descriptive statistics and the result of regression analysis. The final section includes a summary, limitations and future studies that could be expanded from this paper.

Literature Review And Hypothesis Development

This section reviews the existing literature on KAMs, and the relationship between companies' audit committees and KAMs. The reviews help provide possible proof of research problems that demand further investigation, accompanied by the discussion of the hypotheses.

RESEARCH ON KEY AUDIT MATTERS

KAMs in auditors' reports increase the amount of information available to investors to make informed decisions (Velte 2019). Köhler et al. (2016) conducted an experiment to examine the communicative value of an extended auditor report among professional and non-professional investors in German. They found that the economic judgments of professional investors are affected by variations in KAM disclosure. Sirois et al. (2018) investigated whether the additional mandatory paragraphs of KAMs in the auditor's report affects users' information acquisition process, before KAM disclosure become mandatory. They experimentally manipulated the presence of KAMs (one or three KAMs) and audit procedures performed to address each KAM. They found that KAMs have an attention-directing effect, such that KAMs increase users' attention to KAMs-related information in the auditor's report. This finding contradicts those of Carver and Trinkle (2017), who found that KAM disclosure resulted in a less readable report, which did not result in significant changes in investor value judgments.

Although most research adopted an experimental method, market reaction studies provide initial understanding on the implication of KAMs. Firstly, Bédard et al. (2015) analysed the implications of justifications of assessment (JOAs)[2]. The initial findings show that initial release of JOAs does not lead to substantial market reaction. However, subsequent release of JOAs was significantly correlated with greater abnormal trading volume. Reid et al. (2015) found that additional auditor disclosures in risk of material misstatement (RMM)[3] correlated with higher abnormal trading volume and lower abnormal bid–ask spreads. This finding indicates that the new disclosures benefited investors in these companies.

In Thailand, Boonyanet and Promsen (2019) showed that KAMs are of little informative value to investors. However, their result suggests that KAMs relating to the provision of doubtful debt have a positive and significant relationship to stock prices. In addition, Li (2017) concluded that adding KAMs in auditor's report has no apparent advantages. Similarly, the market in China has not reacted significantly to the disclosure of KAMs. In Jordan, Mohammad and Mohammad (2019) evaluated 195 audit reports for companies listed on the Amman Stock Exchange in 2016. They found that the disclosure of KAMs had a significant impact on investors' reaction. Such reaction was measured by the abnormal trading volume, and it indicated that the mandatory disclosure of KAMs would be useful to investors.

Apart from exploring the effects of KAMs on capital market indicators, recent studies investigate factors that influence KAM disclosure. For example, Velte (2018; 2019) scrutinised the relationship between the gender and financial and industry expertise of audit committees' members towards the readability of KAMs. The results show that companies with a higher percentage of women and financial and industry expertise on audit committees have higher readability of KAM disclosures. Additionally, Shao (2020) presented evidence that the characteristics of auditors influence the disclosure of KAMs; audit firm size, auditors' industry expertise and auditors' gender are significantly associated with the disclosure of KAMs. Ferreira and Morais (2020) revealed that a high number of KAMs are reported when a Big 4 auditor produced the final audit report and when the company is complex. Auditors' fees and modified auditors' opinion showed a negative relationship with the number of KAMs. In summary, prior research is extensive, but many aspects remain unexplored, especially factors that influence KAM disclosure.

AUDIT COMMITTEE AND KEY AUDIT MATTERS

Agency theory recognises the importance of effective corporate governance mechanisms to reduce information asymmetry between management and shareholders (Jensen & Meckling 1976). Corporate governance mechanisms help companies achieve their objectives and increase the likelihood of long-term success (Securities Commission Malaysia 2017).

One important component of corporate governance mechanisms is the formation of audit committee. The Securities Commission of Malaysia, through the Malaysian Code on Corporate Governance (MCCG) has mandated the formation of audit committees. The committee is responsible for planning internal audit, appointing the external auditor, advising the external auditor on audit issues and ensuring that financial statements are prepared according to prescribed accounting standards. The formation of this committee reduces agency problem associated with agent–principal relationship between manager and shareholders.

Studies show that the effectiveness of audit committee is associated with the quality of corporate financial reporting (Wan Masliza et al. 2016), reduces earnings management practices (Norman et al. 2007), improves financial reporting and audit report timeliness (Osssii & Taktak 2018; Syaima' & Sherliza 2015; Zalailah et al. 2017) and voluntary disclosure (Hisham Kamel et al. 2013) and reduces the tendency of companies to receive modified audit reports (DeFond & Zhang 2014; Pucheta-Martínez & García-Meca 2014). Norman et al. (2007) found that earnings management practices are low in companies when audit committee members are all independent, financially literate and have high frequency of meetings. Mohid et al. (2009) and Syaima' and Sherliza (2015) provide evidence that effective audit committees can improve the financial performance of companies. Their study showed that the characteristics of audit committees differ significantly between financially distressed and non-distressed companies. Studies have identified three common characteristics as indicators of audit committee effectiveness, namely, independence of committee members, financial literacy of committee members and activeness of the committee.

The oversight functions of audit committees have an effect on KAMs, because the frameworks for determining KAMs start with matters communicated or required to be communicated to those charged with governance. This task is a key function of audit committees. Audit committees provide external auditors with views and details about transactions that affect the financial or audit activities of a company. A preliminary study in Malaysia, which investigates the first year of the implementation of the Enhanced Audit Report, confirms that coordination between external auditors and audit committees is vital, and audit committees play an important role in helping auditors in their KAM selection process (Securities Commission Malaysia 2018). This study predicts that an effective audit committee communicates and resolves auditing issue with external auditors, and such practice could possibly reduce the number of KAMs. Hence, the hypothesis is stated as follows.

H_1: There is a negative association between audit committee effectiveness and the number of KAMs disclosed in the auditor's report.

One of the essential characteristics for assessing audit committee effectiveness is the independence of its members. In Malaysia, Section 344A (2) of the Bursa Malaysia Listing Requirement requires audit committees to consist of a minimum of three members, a majority of which must be independent. An independent audit committee enhances the effectiveness of monitoring function and objectivity in evaluating company accounting, internal control and reporting practices (Norman et al. 2007; Zalailah et al. 2017). Additionally, the modified audit opinion is less likely to be obtained by companies with more independent audit committee members (Carcello & Neal 2003), because members are able to handle financial accounting issues and deal with external auditors better (Sultana et al. 2019). In fact, fraudulent financial reporting has become less common in companies with more independent audit committee members (Beasley et al. 2000).

Klein (2002) stated that independent audit members are more effective and objective in evaluating and monitoring the audit process by external auditors. Independent audit committee members are expected to recommend mitigation plans if companies are faced with financial difficulties or if an external auditor encounters complications during the audit process. Thus, an independent audit committee is predicted to reduce the number of KAMs issued by an external auditor. Hence, the following hypothesis is stated as follows.

H2: There is a negative association between audit committees' independence and the number of KAMs disclosed in auditor's report.

Audit committee members need to have a good understanding of issues in accounting and reporting of financial information because they are responsible for monitoring and advising the external auditor on audit issues and reporting issues in financial statements (Zalailah et al. 2017). Ruzaidah and Takiah (2004) proposed that quality of financial reporting is better when an audit committee is financially literate. Additionally, possible earnings management practices by the management can be prevented because audit committee members are equipped with the necessary financial and accounting tools to detect this behaviour (Ruzaidah & Takiah 2004).

Krishnan and Visvanathan (2009) argued that financially expert audit committees will efficiently determine the quality and adequacy of accounting policies and restrict the aggressiveness of accounting treatments. In fact, audit committee members who are financially expert can offer additional assistance to external auditors when reviewing and resolving auditing issues with the management. With a solid understanding of risk and auditing issues, financially expert audit committees will recommend audit procedures to address difficulties faced by external auditors. Financially experienced audit committees also help companies develop enhanced internal control structures and minimise reporting risk (Sultana et al. 2019). Knowledge in financial accounting and reporting, together with internal control among audit committee members, facilitates coordination and communication with external auditors during the audit process (Kalbers 1992). This coordination could reduce problems during the preparation of an audit report. Hence, audit committee expertise is expected to reduce the reporting of KAMs. Thus, the following hypothesis is proposed.

H3: There is a negative association between audit committees' financial expertise and the number of KAMs disclosed in auditor's report.

An effective audit committee can provide effective monitor role and suggest solutions on issues surrounding companies' operation, especially those related to audit process and preparation of financial statements (Norman et al. 2007). Monitoring can be done effectively if committee members are active, meaning they can meet frequently to discuss operational issues. Evidence shows that frequency of audit committee meetings is associated with higher quality of reporting (McMullen & Raghunandan 1996). Ruzaidah and Takiah (2004) showed that the activeness of audit committee members, measured by frequency of meetings, is associated positively with the quality of financial reporting.

Menon and Williams (1994) found that active audit committee members are more likely to perform their responsibilities more diligently and with higher compliance with regulatory requirements and accounting standards. Companies with a higher number of audit committee meetings face less financial adjustment, are less likely to be sanctioned for fraudulent accounting and are associated with a lower incidence of earnings management (Abbott et al. 2004; Beasley et al. 2000; Xie et al. 2003). According to Menon and Williams (1994), 'although the number of meetings may not provide any indications about the extent of work accomplished during the meeting, it is noted that audit committee without any meeting or with small number of meetings is less likely to be a good monitor'. Therefore, this study predicts that the frequency of audit committee meetings can reduce the number of KAMs, because audit committee members can discuss and clarify auditing issues. Therefore, the following hypothesis is stated as follows.

H4: There is a negative association between number of audit committees' meetings and the number of KAMs disclosed in auditor's report.

Methodology

This research is an exploratory study to analyse in depth KAM disclosure in its first year of implementation (2016) and factors that influence its disclosure. The sample is based on the FTSE Bursa Malaysia KLCI Top 100 index consisting of 30 companies in the Bursa Malaysia EMAS Index and the Bursa Malaysia Mid 70 Index. This study chooses the top 100 as sample companies because they are more likely to have KAMs than smaller companies (Bédard et al. 2015; Gutierrez et al. 2018). These top 100 companies represent more than 10 percent of public listed companies in Malaysia. The 2016 auditor's reports were reviewed to investigate KAMs in companies whose financial year ends in December, whereas the 2017 auditor's reports were reviewed in companies whose year ends in other months. For example, if a company's year ends in March, the first collection of auditor reports to contain KAMs will be the 2017 auditor's report. This study also examines the impact of audit committee effectiveness on the disclosure of KAMs.

Annual reports were analysed to gather information on the number of KAMs reported in the auditor's report, the type of auditor, whether it is a Big 4 or Non Big 4, total audit fees charged by auditor for the current year and company's financial year-end. DataStream Thomson Reuters Eikon was utilised to extract other financial information of the company, such as total assets, debt, profitability and liquidity.

The measurements of KAMs used in this study are adapted from previous studies (Bédard et al. 2015; Ferreira & Morais 2020; Liao et al. 2019; Pinto & Morais 2019). This study develops an audit committee index to measure the effectiveness of audit committee. The index provides a more holistic view on audit committee effectiveness than individual characteristics (Bauer et al. 2010). MCCG 2017 proposed that all audit committee members must be independent. Therefore, this study gives a score of 1 if all audit committee members are independent, otherwise 0. Accordingly, Chapter 15 of Corporate Governance of the Main Market Listing suggests that at least one member of an audit committee should be a financial expert, and an audit committee must have meetings not less than four times in a year. Table 1 presents the detailed measurement of the index.

TABLE 1. Development of Audit committee index

Audit Committee characteristic	Measurement	Index
ACInd	1 if all members are independent, 0 otherwise.	1
ACExpert	1 if the ratio of financial experts on the committee is above the full sample mean and 0 otherwise.	1
ACMeeting	1 if the committee meeting at least 4 times during the year, 0 otherwise.	1
Total Score of ACIndex		3

Table 2 presents all variables and their measurement that are included in the research models. There are seven control variables that have been proven in the past studies to influence auditor's report. A summary description of all variables is in this table.

TABLE 2. Number of Companies with Key Audit Matters (KAMs)

Variables	Definition	Operationalisation
KAMs	Number of Key Audit Matters	Number of Key Audit Matters disclosed in auditors' report
ACIndex	Audit committee index	Refer to measurement as per Table 1
ACInd	Independent audit committee	Percentage of independent members of the audit committee (Nooraisah et al. 2017)
ACExpert	Financial expert audit committee	Percentage of members of the audit committee with accounting or finance qualification (Velte 2019)
ACMeeting	Number of audit committee meeting	Number of audit committee meeting during the year[4] (Nooraisah et al. 2017)
CompSize	Total assets of the company	Natural logarithm of total assets (Bédard et al. 2015; Gutierrez et al. 2018)
Leverage	Leverage of the company	Total Debt/total asset (Bédard et al. 2015; Gutierrez et al. 2018)
Profitability	Profitability of the company	Return on equity (ROE) (Bédard et al. 2015; Gutierrez et al. 2018)
Liquidity	Liquidity of the company	Current asset/current liability
Big 4	Big 4 or non-Big 4 auditor	Dichotomous variable equal to 1 if the company is audited by Big 4 auditor and 0 otherwise (Bédard et al. 2015; Gutierrez et al. 2018)
AuditFees	Current year audit fees	Natural logarithm of audit fees (Bédard et al. 2015; Gutierrez et al. 2018)
Busy	The financial year end of the company	Dichotomous variable equal to 1 for companies with December 31st year end, and 0 otherwise (Bédard et al. 2015; Gutierrez et al. 2018)

The following models are used to test four hypotheses in this research. Model 1 tests the association between audit committee effectiveness (ACIndex) and disclosure of KAMs. Model 2 tests the association of individual audit committee characteristics (audit committee independence, audit committee expertise, and number of audit committee meetings) with the disclosure of KAMs.

Model 1:

$$KAMs = \beta o + \beta_1 ACIndex + \beta_2 CompSize + \beta_3 Leverage + \beta_4 Profitability + \beta_5 Liquidity + \beta_6 Big\ 4 + \beta_7 AuditFees + \beta_8 Busy + \varepsilon_{it}$$

Model 2:

$$KAMs = \beta o + \beta_1 ACInd + \beta_2 ACExpert + \beta_3 ACMeeting + \beta_4 CompSize + \beta_5 Leverage + \beta_6 Profitability + \beta_7 Liquidity + \beta_8 Big\ 4 + \beta_9 AuditFees + \beta_{10} Busy + \varepsilon_{it}$$

Results

DESCRIPTIVE STATISTICS

The FTSE Bursa Malaysia KLCI Top 100 companies are from nine industries namely: Finance (15 companies), Trading (32 companies), Industrial (19 companies), Plantation (6 companies), Consumer (12 companies), Properties (7 companies), Construction (3 companies), Technology (1 company), and REITs (5 companies). Table 3 presents information companies that disclosed key audit matters (KAMs) The table shows that the maximum number of KAMs disclosed during the year is seven (7) and the minimum is one (1). Thirty-nine (39) companies reported two numbers of KAMs, followed by twenty-four (24) companies which recorded only one KAM. One company recorded six and seven KAMs respectively.

TABLE 3. Number of Companies with Key Audit Matters (KAMs)

Number of KAMs	Number of Companies
1	24
2	39
3	18
4	12
5	5
6	1
7	1
Total	100

Further analysis discovered that there are 48 different types of KAMs were reported on the auditors' report. The top five (5) issues as illustrated in Table 4 are revenue recognition, impairment of goodwill and intangible assets, impairment of property, plant and equipment, impairment of investment in subsidiaries, associates and joint-ventures, and valuation of investment properties. For issues of less than 5 frequencies, this study listed them as Other KAMs, item 11. Among the issues in other KAMs are contingent liability, accounting for biological assets, capitalization of borrowing cost, and assessment of post-employment benefits, leasing agreement, litigations, and provision for warranties.

TABLE 4. Top 10 KAMs in sample selected

No.	Key Audit Matters	Frequency
1.	Revenue recognition	41
2.	Impairment and carrying value of goodwill and intangible assets	38
3.	Impairment and carrying value of PPE	24
4.	Impairment in investment in subsidiaries, associates & JV	21
5.	Valuation of investment properties	13
6.	Impairment of loans, advance and financing	12
7.	Valuation of inventories	12
8.	Impairment of trade receivables	8
9.	Deferred tax assets	6
10.	Financial instrument	5
11.	Others	57

Revenue recognition is a common issue frequently found either in the unqualified or qualified auditor's reports (Amirul Hafiz 2019). It is a candidate for inclusion as KAMs in most audited companies as fraud in the revenue recognition is likely to be a topic of discussion between the auditor and the audit committee (KPMG 2017). In this study, revenue recognition is a significant issue in KAMs with 41 appearances. According to ISA 240,

"Material misstatements due to fraudulent financial reporting often result from an overstatement of revenues or an understatement of revenues. Therefore, the auditor ordinarily presumes that there are risks of fraud in revenue recognition"

(ISA 240: Para 60)

In addition, revenue recognition for the building and property industries becomes more difficult because revenue recognition is based on the stages of the completion method. When assessing the stages of completion, auditors have to exercise their professional judgement to decide the future cost to complete. Future costs can be very hard to estimate particularly if the projects take longer period to construct. It can take more than 5 years to develop major projects such as schools, hospitals, and bridge-making. Nobody can foresee something accurately in future because of uncontrollable factors such as changes in economic conditions.

Secondly, KAMs relates to the valuation of goodwill and intangible assets appears 38 times among sample companies. Goodwill attracts auditor attention as the accounting standards require the company to test goodwill impairment annually. It is difficult to calculate precisely the value of these properties, and the effects may have a significant impact on the accounting numbers reported in financial statements, particularly in sectors with volatile economic conditions (KPMG 2017). Therefore, it is reasonable to see that goodwill and intangible assets valuation appears as among frequently reported items since the auditing involve significant audit evidence and judgement.

This study also found that different industries have similarities KAMs issues. For instances, revenue recognition is addressed as KAMs in all industries while impairment of goodwill is in nearly all except for properties, constructions and REITS. Table 5 listed top issues being discussed according to industry.

TABLE 5. Top KAMs issues according to industry

Finance	Impairment of loans, advance and financing
	Impairment and carrying value of goodwill and intangible assets
	Impairment in investment in subsidiaries, associates & JV
Trading	Impairment and carrying value of goodwill
	Revenue recognition
	Impairment and carrying value of PPE
Industrial	Impairment and carrying value of goodwill and intangible assets
	Revenue recognition
	Valuation of inventories
Plantation	Impairment and carrying value of goodwill and intangible assets
	Impairment and carrying value of PPE
Consumer	Impairment and carrying value of goodwill and intangible assets
	Impairment in investment in subsidiaries, associates & JV
	Revenue recognition
Properties	Revenue recognition
	Valuation of investment properties
Construction	Revenue recognition
REITS	Valuation of investment properties

Table 6 shows the descriptive statistics for all the variables in the regression equation. The maximum score of ACIndex is 3 and the minimum is 1. Majority of the sample companies earned a score of 2. On average, the percentage of independent audit committee is approximately 88 percent. Accordingly, detail analysis shows that 57 companies had a 100 percent independent audit committee and the lowest number of the independent audit committee was 60 percent. This means, all top 100 companies in Bursa Malaysia have met the requirements of Bursa Malaysia, which stated the majority of the audit committee must be independent. In addition, there are 18 companies in which all of their audit committee member are financially literate. The remainder of companies met the requirement of Bursa Malaysia to have at least one member of the audit committee with an accounting or finance qualification. Almost 80 percent of the top 100 companies in Bursa Malaysia have more than 50 percent of the financial experts on their audit committee. The study also revealed that on the average, audit committee met six times a year. The maximum number of meeting is 18 times. Detail analysis show that there are seven companies which had meetings more than ten times in a year. Whereas two companies did not comply with Bursa Malaysia's requirement to hold no less than four meetings in a year. These two companies meet just twice a year.

TABLE 6. Descriptive statistics of continuous variables

Variables	Mean	Median	Max	Min	SD
ACIndex	2.13	2.00	3.00	1.00	0.74
ACInd	0.88	1.00	1.00	0.60	0.14
ACExpert	0.64	0.67	1.00	0.20	0.23
ACMeeting	6.05	5.00	18.00	2.00	2.70
CompSize	7.15	7.03	10.45	5.72	0.82
Leverage	0.29	0.28	0.90	0.00	0.20
Profitability	16.13	10.04	101.90	0.00	18.33
Liquidity	3.50	1.39	42.68	0.01	6.77
AuditFees	5.33	5.26	6.91	4.23	0.49

The descriptive statistics for dichotomous variables indicate that 64 companies have ended their financial year in December. The majority, 87 companies, were audited by Big 4 audit firms (KPMG – 31 companies, PWC – 27 companies, Ernst and Young - 24 companies, and Deloitte - 5 companies. Only 13 companies are audited by non-Big 4 audit firms. Big 4 audit firms have more resources and industry-specific knowledge compared to small and medium-sized audit firms (Balsam et al. 2003) and assumed to have a positive impact on KAMs.

CORRELATION BETWEEN VARIABLES

The results of Pearson correlations among independent variables are shown in Table 7. The table shows none of the variables have a correlation of more than 0.7. Therefore, there is no multicollinery problem among the variables (Tabachnick & Fidell 2007). In addition, the tolerance and VIF value in the regressions results are above 0.10 and below 10 respectively, confirming of no multicollinearity problems between independent variables (Hair et al. 2010).

TABLE 7. Correlation between independent variables

	1	2	3	4	5	6	7	8	9	10	11
ACIndex (1)	1.000	.721**	.540**	-.040	.020	-.023	.100	.095	-.089	-.129	-.306**
ACInd (2)		1.000	.111	.014	.021	-.059	.108	.124	-.089	-.091	-.364**
ACExpert (3)			1.000	-.078	.124	-.015	.003	.015	.055	.040	-.062
ACMeeting (4)				1.000	.483**	-.159	-.221*	-.064	.018	.420**	.032
CompSize (5)					1.000	-.086	-.415**	.117	.195	.526**	.057
Leverage (6)						1.000	.066	-.008	.140	.049	.039
Profitability (7)							1.000	-.139	-.113	-.307**	-.026
Liquidity (8)								1.000	-.087	.077	-.101
Big4 (9)									1.000	.332**	.206*
AuditFees (10)										1.000	.203*
Busy (11)											1.000

** Correlation is significant at 0.01
* correlation is significant at 0.05

HIERARCHICAL MULTIPLE REGRESSION

Hierarchical multiple regression analysis was used to investigate the association between audit committee effectiveness and the number of KAMs disclosed in the auditor's report. The results are presented in Table 8. In Step 1, the result show that control variables explain 24 percent of changes in the reporting of KAMs (adjusted R^2 = 24%, F = 4.061, p = <.05). Results in Step 2 show that audit committee effectiveness (ACIndex) is negatively associated with the reporting of KAMs (adjusted R^2 = 25%, F = 3.706, p = <.05). However, the association is not statistically significant. The insignificant relationship may be due to its first year of implementation of ISA 701 and the audit committee had no precedent to observe or experience to draw from (Securities Commission Malaysia 2018). In addition, Pucheta-Martínez & De Fuentes (2007) argued that the presence of an audit committee would not minimise the incidence of mistakes and non-compliance qualifications. Thus, hypotheses H1 are not supported.

TABLE 8. Summary of Hierarchical Regression Analysis - Model 1

Variables	B	t	Sig	R	R2	ΔR 2
Step 1				.490	.240	.240
CompSize	.255	2.186**	.031			
Leverage	.191	2.038**	.045			
Profitability	-.187	-1.808*	.074			
Liquidity	.097	1.026	.308			
Big 4	-.034	-.337	.737			
AuditFees	.110	.941	.349			
Busy	.007	.073	.942			
Step 2				.500	.250	.010
ACIndex	-.106	-1.078	.284			

Note: *** significant at 0.01, **significant at 0.05, *significant at 0.1

The next analysis is to test the individual characteristic of audit committee effectiveness (ACInd, ACExpert and ACMeeting) with KAMs. The results of hierarchical multiple regression are shown in Table 9. In Step 1, the results show that 23.6 percent of variability in the number of KAMs are explained by control variables in the regression equation (F = 3.922, p = <.05). In Step 2, the model adds three individual audit committee characteristics; ACInd, ACExpert and ACMeeting. The results show all audit committee individual attributes associate negatively with the number of KAMs disclosed in the auditor's report. However, only the number of audit committee meetings are statistically significant. This implies that active audit committee is able to provide an effective oversight process, suggest solution on issues surrounding companies' operation, especially on the issues related to audit process, and subsequently reduces the number of KAMs (Norman et. al 2007). This results are supported by McMullen and Raghunandan (1996) and Ruzaidah and Takiah (2004), the frequency of audit committee meetings is associate with the quality of financial reporting. Therefore, hypothesis H4 on the negative association between the number of audit committee meetings and the number of KAMs reported is accepted.

The result in Model 2 also indicates negative association between independent of audit committee with the number of KAMs; and between financial expert of audit committee with KAMs. However, the associations are not statistically significant. The findings are not what this study has predicted. Consequently, H2 and H3 cannot be supported. The results are consistent with Khamsi et al. (2015)'s study, where they discovered that even if companies had met the minimum requirements of the audit committee 's independent and financial knowledge, the companies are still being reprimanded for failure in financial disclosure. It means some attribute of audit committee effectiveness do not have an effect on the quality of reporting. Since this study is for the first year implementation of ISA 701, audit committee members might be relying on external auditor on matters regarding the disclosure of KAMs. Overall, the results showed that the imposition of excessive unnecessary high criteria to be a member of the audit committee may not be reflected in the improved quality of financial reporting (Rainsbury et al. 2009), especially in Malaysia where companies are dominated by family own company and with concentrated family ownership (Norman et al. 2007).

TABLE 9. Summary of Hierarchical Regression Analysis - Model 2

Variables	B	t	sr2	R	R2	ΔR 2
Step 1				.486	.236	.236
CompSize	.336	2.743***	.007			
Leverage	.157	1.670*	.098			
Profitability	-.179	-1.747*	.084			
Liquidity	.069	.722	.472			
Big 4	-.050	-.500	.618			
AuditFees	.191	1.586	.116			
Busy	-.026	-.256	.798			
Step 2				.536	.287	.052
ACInd	-.092	-.926	.357			
ACExpert	-.115	-1.226	.224			
ACMeeting	-.226	-2.017**	.047			

Note: *** significant at 0.01, **significant at 0.05, *significant at 0.1

The influence of the company's financial characteristics is more significant relative to the characteristics of the auditor when considering the effect of control variables on number of KAMs. In particular, the effect of CompSize, which in both models has the highest beta coefficient, means that the company's size makes the greatest contribution to clarifying the number of KAMs issued by the auditor. As reported by Reynolds and Francis (2000), and Lys and Watts (1994), large companies are associated higher potential audit risk and litigation costs due to their business complexities and unique transactions. As consequences, auditor find some issues related to audit process and disclose them as KAMs in auditor's report.

Conclusion

KAMs have become one of the important information that must be reported and highlighted in the auditor's report. Since its introduction and implementation in 2016, no specific study has been performed to gather the pattern of KAMs and factors that influence KAM disclosure in Malaysia. Thus, the first objective of the study is to analyse the disclosure of KAMs in detail. The second objective is to examine whether audit committee effectiveness can have an influence on the number of KAMs disclosed in the auditor's report. The majority of sample companies reported two KAMs, mainly about 'revenue recognition' and 'impairment of goodwill and intangible assets' issues. The evidence also shows that frequent audit committee meetings reduced the number of KAMs. In addition, positive associations were noted between company size, profitability, liquidity and the number of KAMs.

This study contributes to a body of new knowledge by presenting in-depth information on the nature of KAM disclosure on its first year of implementation. Additionally, the empirical results prove that only frequency of audit committee meeting influences disclosure of KAMs. Audit committee independence and financial expertise do not have significance in reducing the number of KAMs. These findings provide an important policy implication whether imposing unnecessarily high criteria of audit committee members can contribute towards informative auditor's report.

This study has limitations. Firstly, the data for this study are collected for only one accounting period and for the top 100 companies in Malaysia. This limitation might affect the generalisation of the findings. Secondly, this study does not differentiate between different types of KAMs and whether they provide 'positive' or 'negative' information implication. Future studies can use a bigger sample size with more years of observation to determine whether this result can be generalised. Future studies can also investigate the nature of KAM disclosure and whether disclosures indicate 'positive' or 'negative' implication. An understanding of possible implications of KAM disclosure is beneficial to management and investors. Additionally, future studies could extend this study's finding by investigating other factors that can possibly influence the disclosure of KAMs, such as ownership structure, complexity of business and industry type. Ownership structure in the Malaysian business environment, which is dominated by family ownership, may provide insights on the disclosure of KAMs.

NOTES

1. Flesh Reading Ease and Fox Index (FREFI)
2. JOAs are identical to KAMs, and have been mandatory in France since 2003.
3. UK Financial Reporting Council (FRC) introduced disclosure rules on significant risk of material misstatement (RMM) in the audit reports of the London Stock Exchange companies starting on 1 October 2012 before KAMs were implemented.
4. Norman et al. (2007) note that the frequency of meeting can also be interpreted as more problems encountered during the audit process.
5. The detail of these KAMs is available upon request.

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