

# KEY AUDIT MATTERS: A PRELIMINARY SURVEY ON RELATIONS WITH THE CORPORATE GOVERNANCE. AN ANALYSIS IN THE ITALIAN INSTITUTIONAL SETTING

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**How to cite:** Moscariello, N., Pizzo, M., Ricciardi, G., & Vinciguerra, R. (2019). Key audit matters: A preliminary survey on relations with the corporate governance. An analysis in the Italian institutional setting. *New Challenges in Corporate Governance: Theory and Practice*, 30-33. [https://doi.org/10.22495/ncpr\\_6](https://doi.org/10.22495/ncpr_6)

**Received:** 22.07.2019  
**Accepted:** 31.07.2019  
**DOI:** 10.22495/ncpr\_6  
**Keywords:** KAM, Corporate Governance, Auditing  
**JEL Classification:** M42, M48

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## Abstract

There are few doubts that in the last twenty years we have witnessed a watershed period for the auditing process. Starting from the case of Enron, followed by Worldcom, Ahold, and Parmalat, it has become apparent that something was out of line with corporate governance, financial reporting, and auditing at the end of the 20<sup>th</sup> century. Several studies have addressed the root causes of this situation looking at the complacency of directors and audit committee members; the avarice of management; the conflicts among analysts, investment bankers and executives; and deterioration of professionalism among auditors (Arnold & de Lange, 2004; Zeff, 2003). However, there are some studies asserting that a further aspect has contributed to this chaos: the audit process itself (Knechel, 2007).

Moreover, the recent establishment of the "Key Audit Matters" section in the audit report introduced some changes in the audit process. The International Audit and Assurance Standards Board (IAASB) issued

a new standard, the ISA 701: Communicating Key Audit Matters in the Independent Auditor's Report (IAASB, 2013). It offers a simple, but precise definition of the concept: "Key audit matters are those matters that, in the auditor's professional judgement, were of most significance in the audit of the financial statements; KAMs are, in all cases, a selection of matters communicated with those charged with governance" (IAASB, 2013: ISA 701, p. 8). Yet, the ISA 701 highlights the importance of an interaction between the auditor and the client's governance in order to suitably disclose the KAMs which can be defined as an additional piece of the audit process.

Taking into account these aspects, the intention of this study is to investigate the interaction, if any, between the external auditor and corporate governance of the client company, trying to figure out if a relationship exists between the quality of corporate governance and the quantity of the KAMs disclosed.

Prior studies have already found supporting evidence about the interaction between corporate governance and audit process, focusing on each of the single phases in which the latter is composed (Bierstaker et al., 2006). Client acceptance is a critical phase in the audit firm's risk management process, given the increased risk of litigation and accounting scandals. Auditors should consider a firm's corporate governance because resource dependence theory posits that the Board of Directors plays a major role in setting and monitoring the firm's strategies and how the firm positions itself in its business environment to achieve its objectives (Pfeffer, 1972; Pfeffer & Salancik, 1978; Hillman & Dalziel, 2003); stronger corporate governance, assessed with reference to the Board of Directors (BoD) and to the Audit Committee (AC), lead to more favorable client acceptance recommendation (Sharma, 2008). Auditors are more likely to accept clients with stronger corporate governance (Cohen et al., 2000; Sharma, 2008). In the risk assessment phase, stronger corporate governance (BoD and AC) leads to lower inherent risk and control environment risk assessments (Sharma, 2008). About the program planning, "The auditor may decide to discuss elements of planning with the entity's management to facilitate the conduct and management of the audit engagement" (ISA 300, paragraph A3); stronger corporate governance (BoD and AC) leads both to greater auditor reliance on internal control and to less extensive substantive audit testing (Sharma, 2008). Finally, looking at the audit process in its entirety, auditors use governance information when making their audit decisions (Cohen et al., 2002).

Taking into account both the mentioned results (explaining the existence of a relationship between corporate governance and the audit process) and the change introduced by the ISA 701 (introducing KAM), the intention of this study is to conduct a preliminary investigation in order to understand if, after controlling for some specific variables affecting the accounting quality, there is a relationship between the

quality of the corporate governance (meant as board composition) and the amount of disclosed KAM in the audit report.

The sample consists of 125 firms listed on the Italian Stock Exchange during the reference period. During the sampling process, we exclude all firms that refer to the GICS 40 (financials) and to the GICS 60 (real estate), because of their peculiar financial reporting rules. Then, we drop from the sample all firms with a lack of corporate governance data and firms involved in business combinations. The relatively small sample size is due to the limited size of the Italian stock market and to our sampling criteria.

Corporate governance data were hand-picked from the C.O.N.So.B. (the Italian supervisory authority for financial markets) online databases and from companies' annual reports on corporate governance and ownership structure. Instead, the data concerning the Key Audit Matters were hand-collected from the audit reports inserted in annual reports of the sampled companies.

The survey will be conducted for the years 2017/2018. The narrow time frame is due to the recent introduction of the KAM, whose communication is mandatory starting from 2017.

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