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**"KEY AUDIT MATTERS AS THE WAY TO IMPROVE THE
INFORMATION GIVEN TO THE MARKET. COMPARISON OF
DIFFERENT IMPLEMENTATIONS IN THE EU AND THE USA WITH
PARTICULAR FOCUS ON BANKS"**

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A handwritten signature in black ink, written over a horizontal line. The signature is stylized and cursive, appearing to start with a large 'M' and end with a long, sweeping tail.

Abstract

The key audit matters paragraph of the new auditor's report highlights the issues that required significant attention during the audit process and the implementation of this concept differs among countries and industries. The question about the reasons for those differences and added value of this section for the audit and stakeholders arises. Due to the recent introduction of the similar concept in the USA, critical audit matters, the comparison of practice in Europe and the USA present particular interest. One of the most sensitive type of institutions in relation to these matters are the banks, and this study aims to analyze and compare KAMs and CAMs among the largest banking institutions of the EU and USA in order to understand how these concepts were implemented as well as the main areas of focus for the audit processes. After the analysis of the literature on the topic, the qualitative research of the matters in the reports of the banks with a help of quantitative analysis, e.g. the average number per report, topics, level of experts' involvement etc. was performed. The results showed that most important topics in the banking industry overlap, with impairment of loans and valuation of financial instruments covering majority of key and critical audit matters, but the difference in definition and in the regulation result in the differences in certain topics coverage. The styles of communication differ in Europe and the USA, in the former the matters description was usually more extensive, while in the latter more investor-oriented and concise, with the less matters reported on average. The key and critical audit matters for the banks reflect the sensitive points for the auditors and managers too, so the main trends and the main issues among the banks were discussed in detail in the thesis, but in general the main expectation for the requirement were met and the increased transparency and attention to these matters are achieved.

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Introduction

The role of audit is providing assurance for stakeholders that the information concerning particular company is trustworthy, accurate and complete. Audit has always served a special function for the markets and economy in general, with audit firms being the independent assurance providers on whether the financial statements are prepared fairly and according to the standards. The audit report increases reliability of financial statements for the users. It is a sort of monitoring mechanism for the enterprises, which should decrease the information asymmetry between different parties and enforces accountability of management. It increases trust, especially investors' trust, in the financial markets and financial reporting therefore contributing in the smooth functioning of the markets. Investors and various stakeholders are currently paying more attention to the auditor reporting after the global financial crisis and subsequent understanding of the importance of honest and informative picture of current position of the company. Moreover, representatives of entities noted that the audit report provides them not only with the new information, which was not mentioned in any other official documents, but also informs about discrepancies between the reports of management and audit reports therefore raising questions about an issue, that would not be even noticed in any other case (Brouwer, Eimers and Langendijk, 2016).

With the development of audit and reporting standards, the audit report is becoming more entity-specific, and nowadays the investors demand more relevant insights from audit report and greater understandability even for people without any special knowledge. The audit report was considered essential even before, the problem was that not many of the stakeholders actually read the report in the formal, standardized format because it was not that easy and informative. Authorities everywhere constantly analyze the needs of the various parties and introduce changes and new requirements. One of the improvements in the audit standards - key audit matters communication, is meant to improve the situation together with other changes named 'the new auditor's report', which is supposed to provide a better understanding of the audit by disclosing key audit matters, materiality, scope of the audit and other information.

The requirement of disclosing the key audit matters in the audit report was introduced quite recently in Europe, and even more recently in the USA in the form of a similar concept called 'critical audit matters', and many questions and doubts appeared around the goals, methods and best practice of these new sections of the auditor's report. In this thesis we are going to understand in detail the key and critical audit matters as concepts, describe the main results of the big changes to audit standards, compare them in Europe and the USA. The current trends in different countries and most common topics reported will be observed too, together

with the consequences of the implementation of these concepts. In chapter 1 we are going to look at the examples of implementation and first analyses and conclusions about these concepts made by the researchers and authorities, as well as opinions expressed by the stakeholders and market participants. Special attention will be given to the banks as institutions presenting particular importance to the economies and being particularly sensitive in terms of key or critical audit matters. After the analysis of different sources, the chapter 2 is focused on our own detailed analysis, which is conducted on the sample of the biggest banks in the EU and USA, where the comparison between key and critical audit matters paragraphs in the auditor's reports is shown. The aim was also to systematically describe the characteristics of the matters among reports of the banks and the reasons on why they were more or less frequent, considering the peculiarities of banking industry. The research methods used are both qualitative and quantitative, where the CAMs and KAMs paragraphs were studied in detail, and the auditor's reports were sorted and analyzed by parameters such as audit firm, number of matters, country, emphasis of matter paragraph presence as well as the matters were grouped by the prevailing topics, with a description of the reasons of inclusions of these topic and their content, the experts assistance needed during the audit process for the matters belonging to particular topics. The topics being specific to the banks and general trends are described and the results are compared with the previous studies analyzed, allowing for the own conclusions and suggestions to be made considering the research performed on the banking industry in the EU and the USA.

CHAPTER 1. LITERATURE REVIEW AND ANALYSIS OF MAIN CONCEPTS

1.1. Literature review

First of all, the regulations and standards were taken as the basis for the analysis of the topic. The regulatory environment differs depending on the country and entity involved. The IAASB was in the process of development of the new standards in order to enhance the audit reporting quality and released in January 2015 ISA 701 standard on the key audit matters communication, which is effective for the listed entities for the audits after the 15th of December 2016. The EU regulators acted in line with IAASB, introducing the requirement (EU) No 537/2014 to report key audit matters for audits of public interest entities (PIEs) from 17 June 2016. Among the first in Europe, Financial Reporting Council (FRC) in the UK introduced the change to audit requirement early in 2013, which was to report ‘assessed risks of material misstatement’ being a broad equivalent of key audit matters. Apart from that, the UK was one of the first countries, together with the Netherlands, to implement the ISA 701 standard back in 2014. The corresponding concept in the USA, the critical audit matters paragraph, was introduced more recently and came into effect in 2019, starting from the large filers. The standards text and official publications made available by the authorities such as IAASB, FRC, PCAOB and others are of great significance for the stakeholders and were used in the thesis too.

There have been many researches trying to explore the ways to enhance the auditor’s report and to understand how it is perceived by the readers. The key audit matters and especially critical audit matters concepts, even though being recently introduced as a standard in Europe in in the USA, were covered by many studies so far. The gap between the stakeholders of a company and the auditor was noticed by the authorities, and studies, such as Vanstraelen et al. (2012), Church et al. (2008), were performed, showing that the auditor’s report does not provide enough information for the readers and the need for less standardized auditor’s report exists in fact. The audit expectations gap as well as information gap were described in Iwanowicz, T. and Iwanowicz, B. (2019), Mock et al. (2013) and Gold et al. (2012) articles, which apart from other matters also focused on the KAM paragraph as a way to reduce the above-mentioned gaps. The expected and real benefits of the new section on different areas were investigated widely too, such as on the financial reporting and audit quality researched by Reid et al (2019) and Klueber, Gold, Pott (2019). The benefit for the corporate governance was described in the article of Tusek B., Jezovita A. (2018). The other researches focused on the benefits and

consequences of disclosing the KAM were Bédard et al. (2014), Gutierrez et al. (2018), Asbahr, Karsten and Ruhnke, Klaus (2019) etc.

There were also a series of research done on the auditor's liability and if the key audit matters section presence in the auditor's report decreases or increases it, namely studies by Kachelmeier, Schmidt, and Valentine (2017), Gimbar et al. (2016), Brasel et al. (2016). Another important stream of research, more recent, is focused on the perceptions of the stakeholders of the KAM concept. The Brouwer, Eimers, Langendijk article published in 2016 was aimed to see to which extent the key audit matters match the significant risks reported by managers and significant accounting policies and estimates in the footnotes. This research also provided insights on the added value of the key audit matters section, based on the Dutch listed entities reports. Christensen, Glover and Wolfe's research was one of the notable studies performed in 2014 in order to understand if the critical audit matters paragraph can change the nonprofessional investors decision to invest or not, especially in comparison to presence of the matter in the footnotes. The new study by Köhler et al., published this year, was focused on the similar issues, having as advantage professional investors involved into the experiment too and describing the way the KAM changes the informational value of the auditor's report. The researches on stakeholders' perceptions and informational value were also performed by Boolaky and Quick 2016, Sirois et al. 2017, Lennox et al. 2018 and others. The publication of Pinto and Morais published in 2018 examined the factors, which influence the KAM reporting itself, such as complexity of enterprise, audit fee, relations between auditor and client etc. Loew, Edgar and Mollenhauer's research of the KAM in the financial industry dated 2019 made a great contribution to the understanding of the significance and special features of KAM for the financial institutions' reports. The relationships between management and auditors in light of KAM introduction was looked upon in the study of Cade and Hodge (2014).

A number of observations in the thesis were based on the studies and publications made by the famous audit firms as well as the audit professional associations. Out of the early ones, Audit Quality Forum publications dated 2007 on the utility of additional disclosures and desired characteristics of the auditor's report were useful to understand the premises of the KAM introduction, as well as EY materials dated 2007 on the peculiarities and stakeholders first reactions to the key audit matters. PWC reviews in the UK and Netherlands of the early results and trends of KAM reported in 2014 and 2015 were valuable sources of the obstacles facing the auditors and managers and general picture of the KAM reporting. More recent studies of Deloitte in Italy in 2018 of the new auditor's report set of standards introductions, Association of Chartered Certified Accountants studies on the key audit matters and the audit

expectation gap on the world scale published in 2018 and 2019 respectively, Mazar's 2018 benchmark of key audit matters by country and industry sector were extremely valuable for the analysis, comparison and general conclusions made for the Europe as a region, Audit Analytics reviews and publications of KAM reported in Europe from 2016 to 2018. The audit reports of several companies were used too, in order to see the examples of the standards implementation and the format of communication chosen by the auditors. All these studies contributed to the further analysis and the main results from some of them will be discussed in detail in the following sections of the chapter 1.

1.2. Key audit matter as a concept

A new paragraph included in the new auditor's report presents the key audit matters (KAM), which are, simply speaking, the most important matters of the audit process performed by auditors, highlighted for the users of the audit reports. The reason for their establishment was the need for more informative opinion of auditor and new relevant, specific information for users of the report and in general, enhancement of reporting standards. Emphasizing and giving attention to the crucial parts is quite valuable for a reader of the audit report. "As a user, it can be challenging to understand what's in the financial statements, let alone how they've been audited", "In today's 'boilerplate' auditor's report, it is not possible for investors to understand where the greatest of those risks lie in the eyes of the auditor" (EY Reporting, 2015) – these are the opinions expressed by the specialists on how difficult it may be to interpret the audit reports for users having a large magnitude of different kinds of reports, and who do not always possess special knowledge and expertise. In other words, the readers of audit reports were confused about the content of audit report and the work done by the auditor and expressed desire for straightforward information about audit process.

Basically, the readers of the reports want to understand better the job performed by the auditor together with the results of this job and to be able to analyze specific company better. The objective of KAM is therefore to increase transparency in the audit process and provide intended users with better understanding and better focus on the status quo situation concerning important issues found during the audit process. After financial crisis 2008 the transparency need became especially evident and was stressed by the chairman of the IAASB, the International Auditing and Assurance Standards Board, precisely "more than ever before, [...] users of the audited financial statements are calling for more pertinent information for their decision-making in today's global business environment with increasingly complex financial reporting requirements" (IAASB, 2012). Therefore, it is not a surprise that certain countries, for

instance the UK, the Netherlands, Germany, Australia, Hong Kong, Poland and others, opted for an early adoption of the new auditor report, one of the biggest enhancements of which was including the key audit matters section. As a matter of fact, the UK and the Netherlands were the first two countries to implement the requirement to report key audit matters according to the ISA 701 for the 2014 year-end audit reports.

IAASB introduced the changes to reporting standards to implement the requirement for reporting key audit matters in 2015. International Standard on Auditing (ISA) 701 was focused on communicating key audit matters in the independent auditor's report. This standard is effective for audits of financial statements for periods ending on or after December 15, 2016. The year 2017 was the first-time mandatory application of key audit matters in the European Union. This is required for all audits of listed entities conducted in accordance with ISAs. Furthermore, public interest entities are required too (for example, in Italy apart from listed entities, those are banks and insurance, reinsurance companies).

The official definition of KAM provided in the ISA 701 is the following : “Key Audit Matters (KAM) are those matters that, in the auditor’s professional judgment, were of most significance in the audit of the financial statements of the current period, selected from matters communicated with those charged with governance” (IAASB, 2015b). Key audit matters are to be communicated in the separate section of the audit report. The definition and brief explanation should be provided for users before the description of matters themselves in order for the users to understand the meaning of the section and avoid confusion. Furthermore, it is essential to note that implementing key audit matters does not change financial statements reporting and forming audit opinion based on the audit evidence gained. KAM section should not influence these processes, there are merely the significant, in auditor’s opinion, matters for the audit process performed according to the guidelines established.

The question that arises immediately concerning this definition is what is to be considered “significant” in the audit of financial statements. The guidelines described in the standard text (called the ‘judgement-based decision-making framework’) determine the course of actions needed to determine the KAM (IAASB, 2015a). It is specifically highlighted that KAMs are supposed to be specific to an entity and audit process, as well as relevant to informational needs of the users. These guidelines are going to be illustrated further together with examples.

Prior changes to the auditor’s report were focused more on providing some additional information on the audit responsibilities and more general aspects rather than audit specific such as auditor’s work and the results of it (Humphrey, Loft and Woods, 2009). The key audit

matters standard ISA 701 in fact is often discussed together with ‘the new auditor’s report’ – a set of changes introduced to the audit reporting standards by IAASB, which are one of the most significant changes introduced in last decades in the audit field. These are in particular, going concern reporting changes, detailed description of auditor’s responsibilities and statement of auditor’s independence and other. The standards were also changed, the main ones describing the new auditor’s report content and context are illustrated in figure 1 below. The results and consequences of these changes are often analyzed together with key audit matters, since they were set in action pretty much at the same time. According to the IAASB, key audit matters standard application is required for listed entities, while European Union regulation 537/2014 requires to communicate these matters for public interest entities. Interestingly, while IAASB allows for a voluntary communication of key audit matters, in Italy it is not allowed to report key audit matters for companies other than public interest entities, presumably to avoid confusion and allow for comparability of those companies (Deloitte Italia, 2018).

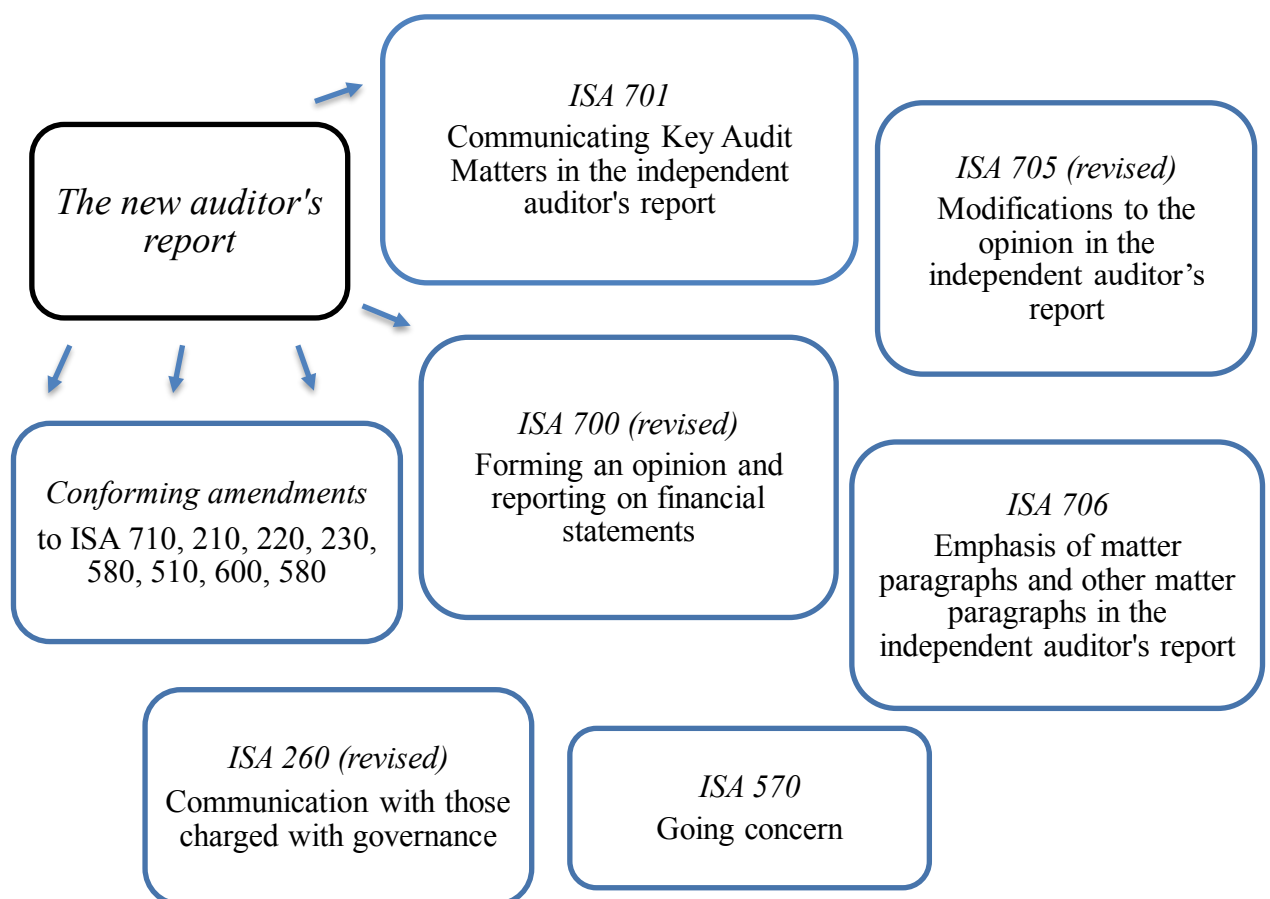


Figure 1. The IAASB standards covering the new auditor’s report

According to the old standard ISA 700, the audit report is quite standardized and consists of description of financial statement of a particular company, the roles of auditor, the

audit process itself and audit opinion as a conclusion. Basically, the auditor's report before was either giving a confirmation that the financial statements are prepared in accordance with the applicable framework or giving the opinion that they were not, as a conclusion from audit performed. The crises and corporate scandals showed that if certain risks would be known before, the tremendous losses could be avoided. Therefore, the auditors were called to share more information, especially related to the particular company being audited. In fact, after performing a quite complicated audit procedures auditors can share more information with public that just giving an audit opinion. So, the authorities thought of the ways to make the audit report more informative and include more insights received from the audit process. And in reality, investors are welcoming this kind of changes, because in this way auditors contribute to decrease of information asymmetry between different parties.

Early in 2007, the Audit Quality Forum working group consisting of investors during the forum in the UK, discussed the utility and need of extra disclosures for different stakeholders such as emphasis of matter, uncertainty and risk references, important issues found during audit process and the ways to cope with them, entity-specific information in the report in contrast to standardized audit reports, more insights on sensitive issues and areas of judgement considered material and many other points. This confirms that the demand for high quality additional information is not recent and auditors are one of the most reliable sources of such information to the investors and the markets in general. 'Investors want more assurance from the audit report, but without all the detailed legal language that is currently a major and standard part of each audit report' (Accountancy Age, 2007). Mock et al. confirms these findings by performing the investors survey which showed the perceived need of more information in the auditor's report. Therefore, the additional disclosures including the key audit matters is a response to the need existing long before of the stakeholders. Authorities and audit organizations are in process of constant research to monitor these perceptions and opinions and introduce measures to influence them and in general serve the goal of audit for the society. The audit report and standards are definitely going to develop with time, responding to the events and publics', especially investors' demands. Key audit matters introduction and in general the new auditor's report were one of the most significant changes lately, but it could be possible that other complementing changes will be suggested in future, since authorities and practitioners are carefully working on that.

1.3. Key audit matters selection process

First, in the process of selection of key audit matters, the auditor determines those matters that required significant auditor attention in performing the audit from the list of matters communicated with those charged with governance (TCWG). Importantly, the following points should be considered during that process:

- Areas of high risk of material misstatement, or other significant risks (according to ISA 315 (Revised)).
- Significant auditor judgments relating to areas in the financial statements that involved significant management judgment (also including accounting estimates with high estimation uncertainty). Impairment of certain assets is therefore likely to be selected, for example goodwill (and in fact likely to be a key audit matter too).
- The effect on the audit of significant events or transactions that occurred during the period. For instance, those can be mergers and acquisitions.

Then the auditor determines which of the above determined matters were of most significance during the audit process of the financial statements. These are, in fact, the key audit matters. The standard provides auditors with the possible features of matters that are considered the matters of most significance:

- those matters that required significant interactions with TCWG;
- those matters, importance of which to intended users understanding of the financial statements as a whole is high, in particular, its materiality to the financial statements;
- those matters, that required high level of audit effort or had high severity of difficulties during application of audit procedures and obtaining audit evidence;
- those that had significant control deficiencies or misstatements both corrected and uncorrected due to fraud and errors;
- matters chosen based on the nature of accounting policies and subjectivity of managers choice of this policy.

In the figure 2, the whole process described above is summarized. This selective process allows to compress information and avoid overload for the readers of the auditor's reports, providing the most useful insights for their decision making.

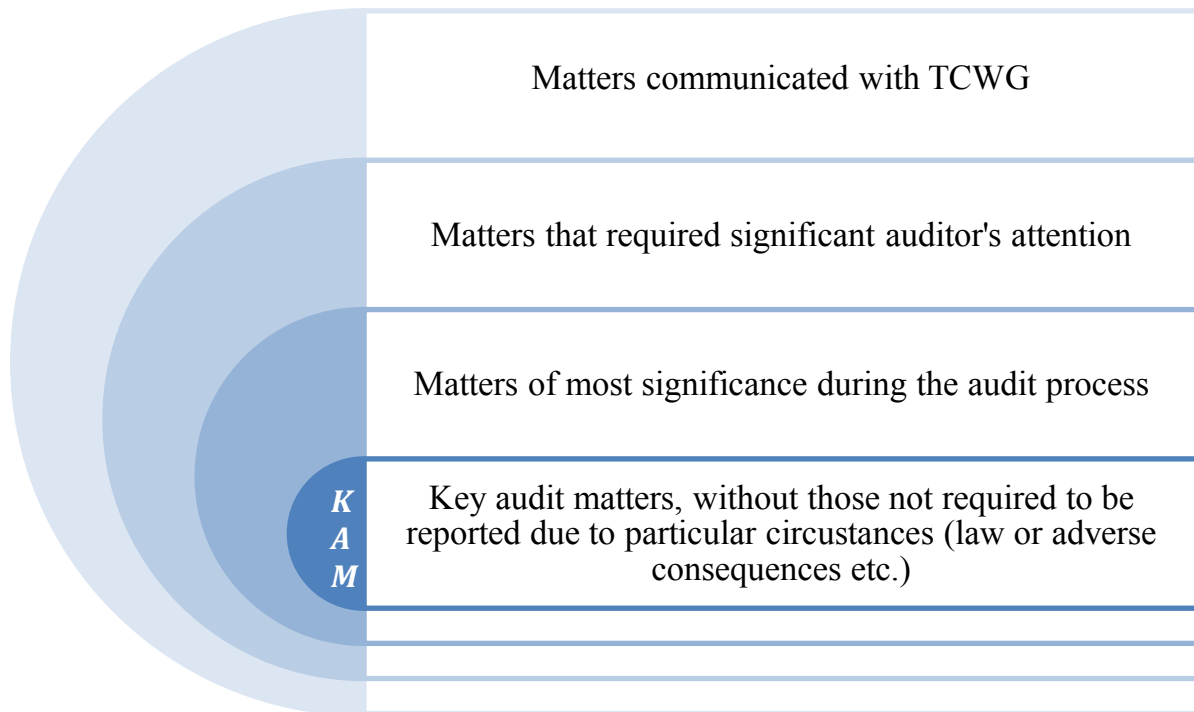


Figure 2. Process of selection of KAMs

According to this process, the number of key audit matters should be lower than matters communicated with TCWG. There is usually at least one key audit matter for a listed company, but the number will of course depend on the size, features of the company and industry in which it is operating (for a high-tech software company revenue recognition may be an issue, while for a large retailer there would be different ‘weak spots’). Moreover, it depends on the way the audit was performed and auditor’s judgment, because in the end they decide which matters were of great significance. Theoretically there can be cases, in which a key audit matter may be not required to be reported, as if there could be significant adverse consequences of publicly disclosing, which prevail the benefits, or if it is not allowed by a law. However, this kind of situations are relatively rare (IAASB, 2015b). Another case when the key audit matter section is not included in the report, is when the disclaimer of opinion is issued in the auditor’s report, i.e. auditor is unable to form an opinion.

In order to briefly illustrate for the beginning the concept, the examples of key audit matters could be the following: change of CFO, valuation of benefit pension assets and liabilities, goodwill, revenue recognition, new standard implementation. However, these matters have to satisfy the definition and follow the guidelines in the standard, just by itself any significant event or change within the company cannot be considered a KAM. The indicators and the selection process of key audit matters in the audit process are widely discussed, but it is pointed out that actually sometimes it is hard to figure out what is not a KAM. Campbell for the EY publication states that sometimes a certain transaction may seem complicated and

requiring a lot of effort but in reality, can be pretty straightforward without the need of special attention or additional discussion. He provides the example of share buyback that can seem significant by looking at a huge number, but pretty simple for audit process (EY Reporting, 2015).

Concerning the communicating the key audit matters, different jurisdictions have different rules on the content of the key audit matters section, however normally it indicates the following points according to ISA 701 (IAASB, 2015b):

1. Description of the matter
2. Reasoning on including a certain matter into the section
3. The description of audit procedure performed and auditor's response relevant to the matter
4. Disclosure of financial statement to which it is related (if such is present, not necessary)
5. Other crucial observations

The IAASB explicitly highlights that the key audit matters should NOT:

- Provide a so-called 'piecemeal opinion' (i.e. opinion on separate lines of the financial statement).

Key audit matters are derived from the audit process and give the information based on the result of this process. They should be determined by considering the audit of financial statements as a whole. The possible key audit matters may be outlined at the beginning stages of audit process and communicated with audit committee, but the final version of key audit matters should be derived from the results of audit process in general, therefore after it is completed

- Be a substitute for any other requirement, disclosure or opinion required by the reporting standards.

This is the point that should be researched by looking at the real-world examples, if the auditors are actually providing useful new insight by including key audit matters or is it being interpreted and implemented in a different from intended way.

- be described opaquely, with overcomplicated audit terminology and be generic,

KAMs should be specific and show how a certain issue was addressed. The auditor preparing the report should keep in mind that it is being written for the users, who do not always possess the knowledge of the audit terminology.

- include any information, which was not available to general public before.

The management should be encouraged to provide the necessary additional information, but as a rule, original data cannot be provided in the key audit matters section itself by the auditor. ISA 701 explicitly stated that the information should be consistent with the disclosures in the financial statements (IAASB, 2015b).

The exact way of how key audit matters should be disclosed is not given, there is no particular order to be followed, but it is recommended to be done in a way that it is more readable for users. For example, the professional accountants association ACCA advises using a table separating the points to be written for each matter (description, audit procedure and response, etc.), and moving this section to the beginning of the report (ACCA, 2018). Very often we can see that auditors make two columns – description of the matter and how the audit addressed the matter. As an example, the auditor’s reports prepared by PWC, frequently had a following structure of key audit matters paragraph presented in the table 1.

Key Audit Matters	Auditing procedures performed in response to key audit matters
<<Title>> <i>‘Valuation of the recoverability of goodwill’</i> <<Reference to financial statement>> <i>Note 1.1 to the consolidated financial statements “Goodwill”</i> <<content>>	<<content>>

Table 1. An example of KAM section structure

In the end, the auditor needs to see if the key audit matters are being appropriately addressed by managers of a company and to check if the financial statements contain all necessary information related to the matters. This way financial report together with audit report provide for additional value for various stakeholders.

The Emphasis of Matter and Other matters paragraphs (described in ISA 706) are sometimes being confused with key audit matters in the report. In reality, emphasis of matter is used in order to highlight certain matters disclosed in the financial statement that were not

included in the key audit matters but are fundamental for readers' understanding of the report in the auditor's opinion. The Other matters section may be included in audit report in addition to key audit matters if auditor is sure it is needed. There the matters other than those disclosed in the financial statements, but that are informative for users' understanding of the auditor's report are mentioned. The certain matters may be defined as both key audit matters and other matters or emphasis of matters, but in this case, they are included as key audit matter and not mentioned in other two sections. In other words, if a matter meets the definition of a key audit matter, it is always included in KAM section, even if it can be included in any other section. In fact, it was expected and confirmed that after the introduction of key audit matters paragraph, the number of emphasis of matter declines, as shown by Deloitte study in 2017 (Deloitte Belgium, 2017). If a certain matter is not considered to be a key audit matter by auditors' judgement but matches the definition of one of the other two sections, it can be included there, and in that case a separate paragraph should be written for this section. Anyhow, nor emphasis of matter nor other matters section cannot substitute key audit matters and key audit matter definition prevails in case of overlap.

The relation to going concern section of the auditor's report (Material Uncertainty Related to Going Concern), which is required according to ISA 570 in the situation of material uncertainty when there is doubt about the continuation of the company as a going concern and future existence of the audited company. This situation is by its nature a key audit matter, however, the standard prescribes not to describe this matter in the key audit matters section, but to include a reference to Material Uncertainty Related to Going Concern section, where it is to be reported in accordance with respective standard (IAASB, 2015b). Nevertheless, it has been found by ACCA study of KAMs in different countries, that in practice the above-mentioned concepts and key audit matters are often a subject to misinterpretation or certain level of confusion (ACCA, 2018).

The relation to the risk paragraph in the annual report of the company to the key audit matters section is a relevant question too. The management in the preparation of the risk paragraph should indicate the areas of significant risk and uncertainties in the company, such as the operational risks, financial, strategic, compliance risks etc. By and large, key audit matters are representing the financial reporting risk and are not required to represent all of the risks in the company. Of course, the key audit matters usually relate to the risks outlined in the annual report, e.g. goodwill impairment risk, but the interesting point is that sometimes they relate to a certain risk that are not mentioned by the management. According to the PWC research in the Netherlands, approximately one third of key audit matters in the majority of the

reports related to some risks that were not included into risk profile. This again confirms the additional informational value of the key audit matters. Examples of such risks included management override of internal controls, fraud in revenue recognition, vendor allowances and others (PWC Netherlands, 2014).

1.4. The consequences of the KAM implementation

Public's attention to the audit process and expectations from the auditors brings certain ambiguity for the users of audit reports and society in general about the auditor's job and responsibilities. Public opinion is that auditors have to prevent and detect all fraudulent activities, which is implausible. The barrier or distance between auditors and readers of the report is often discussed in terms of expectation gap and information gap, the latter being similar to the information asymmetry problem. The difference between what people want from the auditors and what actually auditors do drive the former, and even though the audit standards and requirements evolved through time, the expectations of what auditors should do grew together with the improvements in the audit. IAASB empirically researched and analyzed the perceptions and opinions of users of the auditor's reports together with the gaps existing between the users, auditors and management. IAASB defines the expectation gap as "the difference between what users expect from the auditor and the financial statement audit, and the reality of what an audit is" and the information gap as a "gap between the information they believe is needed to make informed investment and fiduciary decisions, and what is available to them through the entity's audited financial statements or other publicly available information" (IAASB, 2011, pp. 7-8). Authorities also constantly seek to edit the requirements in order to provide extended information in the report for users and to narrow the existing gaps introducing different updates to current regulations, the new structure of the audit reports or completely new standards.

The expectations gap can be divided into three subparts - knowledge gap, meaning a difference in the perceptions of what auditors do from what the auditors actually do; performance gap, which is the difference between what auditors supposed to do and what they actually do; and evolutions gap, being the difference between what auditors supposed to do and what the public wants auditors to do. The figure 2 illustrates the division of the audit expectation gap described above.

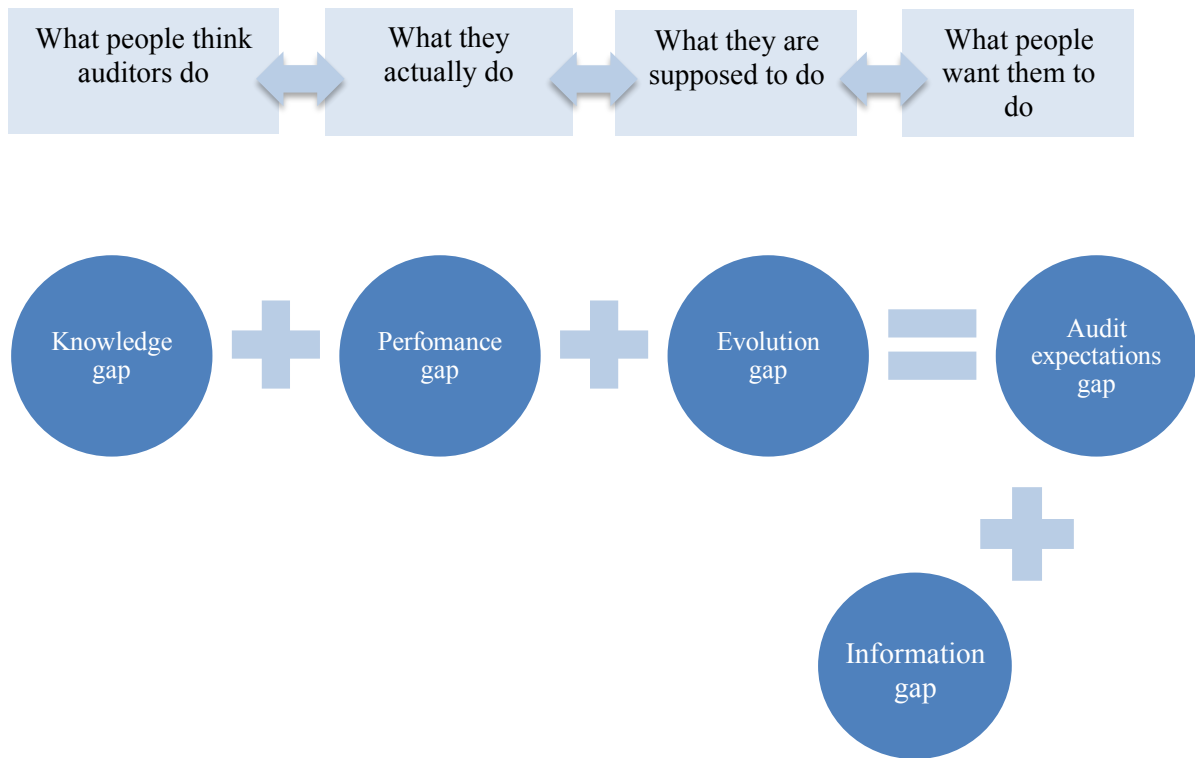


Figure 3. The gaps between auditors and the stakeholders

The possible measures of narrowing the audit expectations gap are being discussed quite often, such as to inform the stakeholders of auditor's actual responsibilities and thus increase awareness and satisfaction as well as avoid conflicts between parties and enhance audit reputation as profession serving an important role. The key audit matters are assumed to reduce in particular the knowledge gap among them all by ACCA study on closing the expectations gap in the audit (ACCA, 2019). It is quite important for the evolvement of audit standards, because reduction of this gap helps with focusing on suggestions for improving the issues that actually exist and not just perceived by the public because of ignorance. KAMs clarify the auditors' job and work being performed. The key audit matters not only discuss the main issues arising during audit process, but also describe how they were reviewed, verified and addressed by auditors. The part where auditors explains how they responded to particular matter and which audit procedures perform is especially useful in this context. Additionally, it was found in the study of Iwanowicz, T. and Iwanowicz, B. that implementation of ISA 701 standard limited the audit expectation gap by making the auditor's report more useful and understandable for readers and with the help of closer and more productive cooperation of audit committee and auditor preparing the report. In fact, they also collected the opinions of auditors, which were welcoming the changes and were of opinion that they are going to restore public confidence in the audit and show a real value of audit (Iwanowicz and Iwanowicz, 2019).

To a certain extent, more than expectation gap, key audit matters were established by authorities to reduce the information gap, which is a gap between what users of financial reporting need for their decision making and what is available for the in the financial reporting. The additional information value provided in the key audit matters section is indeed serving an important role for the stakeholders. As written in the research of Loew, Edgar and Mollenhauer, stakeholders gave a positive feedback concerning the reduction of the informational gap and valued the additional insights provided as well as confirmed that the communication between the involved parties, such as audit committee, management, stakeholders and regulators, improved indeed is also decreasing the expectation gap discussed previously (Loew and Mollenhauer, 2019).

The main goal of providing useful insights for investors and additional valuable information is quite obvious and the key audit matters can be indeed considered a useful caper of the auditor's report. Other main benefits of key audit matters introduction, apart from the narrowing the existing gaps and providing additional information for the users, according to the Association of Chartered Certified Accountants (ACCA) and Mazers studies, are related to the three important topics:

1. Corporate governance

Thanks to the introduction of key audit matters, the communication between auditor and those charged with governance is closer and more frequent, especially interaction between audit committee and auditors. Currently it is more focused on significant issues and therefore more efficient and transparent, thus can help in solving the agency problem and improve the corporate governance. In the EY publication, the positive feedback was received from audit committee members and KAM were seen as opportunity to engage with the auditor more (EY Reporting, 2015). Discussions about selection and description of matters and informing each other about the most important issues in terms of an audit and how they relate to the disclosures, are providing better perspectives and improves audit quality as well corporate governance quality. This proves that communication between auditor and audit committee of a company was made more focused and efficient with introduction of the new standard including the key audit matters (ACCA, 2019). The additional tasks of the audit committee due to implementation of key audit matters paragraph are to rigorously consider time frames of communication with auditor, to make sure disclosure to which key audit matters relate to are well described, to check if any additional disclosure not required by financial reporting framework is needed in order to understand properly the key audit matters selected by the auditor, and to make sure the auditor does not provide any original information. The audit committee is, with a high probability,

going to communicate to management concerning their response to key audit matters therefore contributing to the enhancement of the financial reporting and audit process in general. It was highlighted in Deloitte study that in Italy, this closer communication between the involved parties, in particular the audit firms, authorities and management of companies resulted in a higher level of transparency of audit process and improves the quality of it (Deloitte Italia, 2018).

2. Financial reporting quality

The benefit for financial statements and financial reporting in general could be explained as the key audit matters serving as a motivation for better reporting practice of managers. The positive influence on financial reporting quality was also proved in the study of Reid et al on the UK experience with the key audit matters (Reid et al., 2019). IAASB made a conclusion, that managers, who are directly involved in the preparation of financial statements of the audited company, pay greater attention to key audit matters disclosures, which may as well indirectly influence reporting behavior. In other words, managers alter their actions in preparation of financial statements, having this expectation of auditors disclosing key audit matters. This point in fact was confirmed by the experimental research among managers, which showed that with key audit matters in place, managers were less prone to aggressive financial reporting decisions, for instance choosing higher goodwill impairment amount, since they knew that their judgments will be scrutinized in a greater detail than when compared to the situations, when auditor report was prepared without key audit matters section. Interestingly, Klueber, Gold and Pott claimed that this mechanism for reducing aggressive financial behavior of managers seemed to work irrespective of how entity-specific the key audit matters section was, which proves its effectiveness in any case (Klueber, Gold and Pott, 2018). This goes in line with the research of Cassell, Myers, & Seidel showing that transparent disclosure decreases the probability of managers involving into earnings management to make the business result seem better than they actually are (Cassell et al., 2014). In addition, psychological accountability research confirm that too, stating that the expectation of a person to be asked about the decision or opinion presented affects judgment and makes the person do the job more responsibly, feeling more pressure from possible future any type of control (Tetlock and Manstead, 1985). Therefore, with the help of indirect impact on the management of the audited companies, the improvement of financial reporting quality is one of the main benefits of the new audit standards introducing key audit matters, supporting the authorities' initial expectations and hopes.

3. The audit process itself and to the auditors

The last benefit is to the audit process itself, meaning that that auditor will apply more careful judgment to the areas requiring audit attention. Public sees audit as a crucial process in improving the quality of corporate reporting, therefore it is very important point. One of the researches also supposed that auditor's behavior is supposed to be altered too, since auditors in presence of key audit matters reporting requirement are expected to make a greater effort due to feeling more accountable for the result of their work. However, the analysis performed on the UK experience in Ried et al study shows, that the financial reporting quality improved due to the 'threat of disclosure', that the auditors do not seem to feel more accountable due to the introduction of key audit matters. In fact, the results of comparison between two years before the introduction of the standard and two years after, confirmed the enhancement of financial reporting quality, through the lower abnormal accruals, lower propensity to meet or beat forecasts, both of which basically indicate lower level of earnings management. Investors perceived financial reporting quality higher too after the new audit standard implementation. Interestingly, the research concluded that these financial reporting improvements were not associated with increased costs (audit fees) or more time to prepare audit reports (audit delay). Therefore, the previous benefit described, the one for financial reporting, is indeed present in practice, though to a larger degree due to the altering the managers reporting behavior and perceptions, and to smaller degree due to the changes in the auditors' behavior (Ried et al., 2019). Moreover, the benefit for the auditors themselves is present as well, meaning the enhanced perception, reputation of the audit as a process and profession together with clearer understanding of auditor's job for the clients and public. However, there are still debates happening over the concept and both advantages and disadvantages arguments are described in detail further.

There is also a stream of research discussing if the client pressure could have some effect on auditor's judgement, meaning that they will more likely stick to the client views on certain issues and that this will moderate the result of key audit matters reporting. Even though older research of Gibbins, M., Salterio, S., & Webb, A. and Bhattacharjee, S., Moreno, K., dated 2001 and 2003 respectively, seemed to be sure that auditors are more likely to justify management decision using accounting ambiguity in presence of certain pressure or conflicts of interest, the more recent research, such as Asbahr, Karsten and Ruhnke, Klaus in 2019, discussing this influence on key audit matters does not confirm previous opinion. Actually, the requirement of reporting key audit matters kind of indirectly makes auditors more diligent due to the special attention to these matters. In other word, in case of undetected error or misstatement, the auditor will most probably bear a reputational loss. Therefore, auditors will be more eager to search for information and evidence of a managers' mistake. Nevertheless,

this is an arguable statement and still has to be confirmed in practice, because so far it is just an expectation. Additionally, since key audit matters are of the most importance during the audit, they are at the same time pointing to the matters of high uncertainty and risk. Reporting key audit matters was not found to significantly influence the audit effort (Asbahr and Ruhnke, 2019).

There was also reported that key audit matters allowed to open more new information, some of which was available only to audit committee or managers. It is sometimes thought, for instance in the study of relationship between KAMs and the risks in the management report, that management does not provide enough information and do not always put emphasis on the crucial and risky issues of the company, and auditor report puts the light on these matters therefore lowering the information asymmetry among different parties (Brouwer, Eimers and Langendijk, 2016). Also, it is quite beneficial that, the comparison and benchmark processes can be done among many companies and countries, which will be further illustrated too. All of these points increase the level of stakeholders' trust to audit in general.

Those benefits described above are quite similar to the intended benefits outlines by IAASB such as (IAASB, 2015c):

- increased transparency about audit and highlighting the significant matters for users
- improve communication between investors and auditor, auditor and audit committee about those matters
- increase of focus of auditor on these matters and increase, which also indirectly will lead to an increase in professional skepticism
- increase attention of management to the financial statements' disclosures, which are referenced to in the audit report
- giving users a basis to further engage with TCWG concerning those matters.

The intended effects and the real benefits overlap, and some real benefits were achieved through indirect influence of the KAM. One of the additional benefits for users noted by Deloitte can be also possibility of comparability between key audit matters of similar entities in the same industry. From this the quality of audit performed and general picture of industry could be extracted therefore giving valuable insights from investors and stakeholders in general (Deloitte Belgium, 2018).

Investors were of opinion that the key audit matter paragraph in the auditor report is a good change and useful for them, with note that graphic or concise presentation of them was

considered the most valuable. In the new research of Köhler et al among investment professional from Germany, USA, UK, Canada and some other countries, they tried to see if the key audit matters section brings communicative value by analyzing whether it changes the way the professionals perceive the economic state of the audited company and their confidence in making this conclusion of the economic situation of the company. By performing an experiment with goodwill impairment section, one of which suggested that even small changes in the assumptions can lead to goodwill impairment and the other one discussing that only big changes in those assumptions can lead to goodwill impairment. Since in the former case the probability of impairment and subsequent decrease in net income is higher, they assumed that this can be perceived by investors as a negative factor on the economic state of a company. On the contrary, in the latter case the influence is positive on perception on the state of a company. They underline in the paper, that key audit matters do not always imply a negative view of readers on the certain matters or disclosures in the financial statements. Contrary to the expectations, they actually found that in case of small changes leading to impairment, the economic situation is considered significantly better by the investors, and vice versa. Moreover, in this case they indicate a higher level of confidence in making this conclusion. This can be connected with the trust of investors and believability of the information prepared by auditor. The investors considered such information as new additional insight prepared by auditors in order to help investors make a more objective and accurate assessment of audited company. Therefore, investors believe this information more and have a positive opinion of the report and company too. This paper in fact provides with an extremely useful lesson – that nor auditors nor management should not be afraid of somehow critical information about the entity, any additional information is perceived positively by investors because it allows for decrease of information asymmetry and increase in the level of trust between all the involved parties. This agrees with the early discussions about additional value of any new information that investors and other stakeholders get – communicative value hypotheses, with investors having particular trust to the information from the independent party, the auditor. This research is especially valuable since it collects the opinions about key audit matters section content and since actual investors participated in the project (Köhler, Ratzinger-Sakel and Theis, 2020).

Nevertheless, it had been sometimes noted, as claimed by Brouwer, Eimers, Langendijk, that auditors may describe the matters not in entity-specific way but include more a general reasoning on why a certain matter may be included in key audit matters section. This is, obviously, not the desired practice and the more precise and related to the particular entity information is included the more useful the disclosure is for the users of the report. The important point, in order for key audit matters to be effective as an improvement, is that it

should be enforced and actually implemented by the auditors not as a mechanical compliance job to do, but as a method of better communication with stakeholders and enhancement of the reporting (Brouwer, Eimers and Langendijk, 2016).

1.5. Analysis of KAM reporting trends

There have been a number of researches done on the statistical aspects of key audit matters. The average number of key audit matters reported in Europe was three matters, according to the report of Audit Analytics of analysis of 2300 audit opinions of more than 1200 European listed companies over 3 years from 2016 to 2018 depicted on the figure 4 (Audit Analytics, 2019).

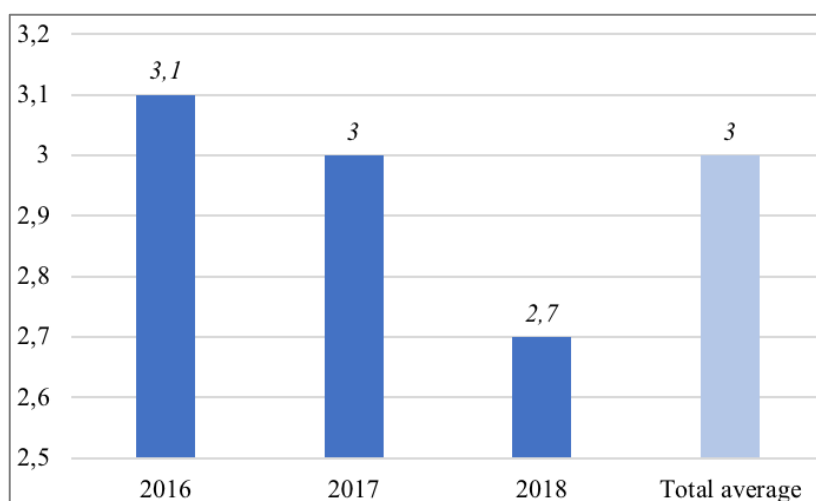


Figure 4. Average KAM numbers in Europe by Audit Analytics

The numbers however differ based on certain characteristics of entities. It has been mentioned, that for larger entities the number of matters reported is higher. In Italy, during the first year of application of the key audit matters requirement, among 221 enterprises the mean number of key audit matters reported was 2.2 and median 2. Deloitte study in Italy found that for the companies with high capitalization, which were selected among FTSE MIB index companies, which the 40 most traded stocks on Milan exchange index, the mean number of matters was 3.2 and median 3 (Deloitte Italia, 2018). It was confirmed that with the increase in market capitalization of the company, as well as with increase in a number of business segments in the company, the number of key audit matters reported rises, which is quite logical and in line with expectations about bigger and more complex enterprises. Though it has been noted that there should not be too many key audit matters reported, since the more they are the more they dilute importance of each other (Pinto and Morais, 2018). Considering the difference across industries in which companies operate, some of them like banking, insurance,

telecommunication were seen to have averagely more key audit matters in the audit reports than the others, which can be explained again by complexities of operations performed by these sectors and some special compliance requirements existing only in those fields (Mazars, 2018).

The variation by countries is not expected to be so evident, at least across European countries, while the most obvious difference is in the UK. The study of Mazars, international audit, accountancy and advisory firm, concluded that France and the Netherlands had 3.3 and 3.7 mean numbers reported respectively, while the average number of key audit matters reported in UK reports is the highest across different industries – 4.1. The primary reasons for this could be that the United Kingdom was the first country to introduce key audit matters, early in 2013 compared to 2017 in EU and that specific regulation in the UK exists, which complicates certain accounting procedures. The guidance on the preparation was developing and the authority based their recommendation on the mistakes made in the first years of implementation. The auditors simply did not have examples of good practice and included all perceived risks in the key audit matters. In fact, the significant difference was noted between the reports prepared in 2013 and late 2014 by IDW (Institute of Public Auditors in Germany) (Deloitte Italia, 2018). They reported that the matters in general did not recur, and key audit matters reporting was not static in the first two years, in contrast to the years after and until now. The Financial Reporting Council (FRC) completed the research and estimated how entity-tailored the key audit matters sections are across the reports of big audit firms such as PWC, EY, KPMG, Deloitte and others by looking at the wording they used. They found that the second year the key audit matters in the auditor's reports analyzed were more specific, which confirms the previous assumption about the learning effect too. The granularity level of the reports of these firms increased, with the most outstanding example of PWC, having only approximately half of the texts being entity-specific the first year jumping to the more than 90% of texts the second year. In other words, the first year was more like experimental, while the second year the firms realized the best way to communicate the matters in their reports, so the learning effect is significant for the KAM (FRC, 2016). The first years of implementation of the key audit matters in the other European countries and the USA may also be expected to evolve and have a learning effect during first reporting periods. Nevertheless, since there are more information and experience from other countries such as UK present, the first years may be less drastically transitional and experimental. Another example concerning the topics covered by the matters is the case of revenue recognition having risk of misstatement because of fraud being a common matter reported the first year. However, ACCA study stated that it was not considered useful by the authority and thought to be too generic and not compliant with the requirement for the matters to be significant in the current period therefore decreased in

usage the next years (ACCA, 2018). Apart from having learned from their own experience, the UK experience contributed to the introduction of key audit matters reporting also in other countries. The surveys and analyses performed there gave an understanding for the European authorities and auditors to better implement the new standard.

The example of accounting complications in the UK, being possibly another explanation for a much higher average number of KAM reported, could be the pension schemes, which are heavily regulated in the UK, therefore providing a higher level of accounting complexity thus contributing to higher level of key audit matters reported on this topic compared to other countries in Europe. Another point made by Mazars overview was that the UK reports included more key audit matters on similar topics instead of combining them into one title (Mazars, 2018). Anyway, the reviews from the enhanced audit reports were quite positive even for first years, says PWC research in 2015. The most valuable section of the auditor's report was chosen to be key audit matters and investors confirmed that they are in need of auditor's opinion on main risks during the audit process and how they responded to them point. The reports with more tailored approach for a certain company and specific information given in contrast to standardized wording is preferred (PWC, 2015).



Figure 5. Factors that impact KAMs reporting

In general, the different studies show that the factors illustrated above may influence the process and results of identification of key audit matters for each audited entity, such as the number and topics.

The research of Tušek focused on the presumable differences between the audit firms in terms of application of the new standard. The expectation and initial data from some countries showed that the small audit firms communicate less key audit matters than the bigger firms and that the audit reports from latter are more extensive (Tušek and Ježovita, 2018). The differences between audit firms' data does not seem to be drastic, according to the data from Europe available in Audit Analytics website, however big four provided slightly bigger average number of key audit matters - 2.58, compared to non-big four firms with 2.29 matters in 2019. Nevertheless, in 2018 this gap used to be bigger with the average 2.6 compared to 2.2 matters respectively, which proposes that the gap may slowly narrow (Audit Analytics, 2019). The assumption was that the numbers of key audit matters reported by different audit firms will differ because of different understanding of key audit matters by each of them as well as various approaches taken. The European study in the financial sector by Loew, Edgar and Mollenhauer refused the idea of certain audit firms reporting more key audit matters and suggested that this is a fallacy, where other factors such as size of the bank influence the number of matters reported significantly. The data may show certain higher or lower average number for audit firms, but it may be due to the fact that some firms prepare audit reports for larger institutions, some for institutions in one industry more than other etc. (Loew and Mollenhauer, 2019).

The important note is that the analysis of statistical aspects is performed across Europe, since the practice and standards in other parts of the worlds are less homogeneous and show more discrepancies, for example Asia and Middle East have their own peculiarities and seem to differ much more significantly in terms of KAM practices, while European countries follow more or less similar trends and comply with similar requirements. The names of the groups of thematically united matters may differ a little in different studies, but in general the majority of topics show great level of resemblance among different countries, at least in Europe. Audit Analytics reported assets impairment, revenue and other income, valuation of investments, income taxes and business combination as the most common topics of KAMs in Europe in 2017. The Mazars research in UK, Netherlands and France shows that assets and goodwill impairment, provisions, taxation disclosure, presentation or classification represented nearly a half of all key audit matters analyzed. In Italy across different industries in 2017 top five topics included valuation and impairment of goodwill and intangibles, revenue recognition, accounts receivables and loans, provisions and taxation. Next we are going to discuss them to see which difficulties they present for the audit process.

- Impairment of assets and goodwill

The intangibles presented more difficulties in valuation and impairment together with valuation of business acquisition and investment impairment, which were often mentioned too. Deloitte research in Italy showed that it was the most common topic in 2018 auditor's reports and there was at least one matter related to goodwill and intangible assets in 64% of all analyzed auditor reports (Deloitte Italia, 2018). The topic concerned brands, assets with indefinite useful life, rights etc. which are considered being prone to subjective assumptions, forecasts for future and valuation, together with frequently impressive amounts reported. Their recoverability should be verified and the auditors has to perform checks on the procedures performed inside the company, involving significant level of difficulty for the auditors, because slight changes in models and assumptions, such as attributing the asset to certain cash generating unit, used by managers may have huge consequences on the amounts, which are often material and significant. Interestingly, outside expects were quite often, in 83% of cases, invited to preform special audit procedures, for instance concerning valuation models. Impairment of assets was the top key audit matter topic in France and UK too (Mazars, 2018).

- Revenue recognition

Revenue is one of the indicators allowing the valuation of performance of the company, as well as presenting a difficulty since revenue is sometimes quite complicated to measure, for example in the case of long-term contracts. Among other things, revenue is one of the indications for the listed companies at which stakeholders look at when measuring performance before purchasing the stocks, therefore being important for the auditors to look deeply into too.

- Provisions and taxation

Issues related to taxation and especially differed tax assets or less often liabilities were mostly mentioned due to materiality of the subject to the audit and not a great level of objectivity in the estimation of future taxable income. Auditors usually need expert opinion on these matters during audit process. Provisions and contingencies may relate for different kind of risks and or disputes, claims and litigations. Estimation process are frequently present there and auditors need to review these estimation processes, which sometimes can be complicated and require substantial audit effort together with expert help. This is an important issue for many enterprises, especially for those heavily regulated, facing higher risk of legal disputes and may be even reputational losses.

It is worth mentioning that key audit matters topics were mostly anticipated to show similarities according to the industry sector, since some industries have different sensitive areas

or areas of risk, which are supposedly visible in audit process too. The financial institutions, especially banks, are definitely the ones being different, which will be analyzed further in this research, due to the nature of the activities and complications in assets valuation and in general preparation of financial statements. In fact, this is the industry, which can be considered the most sensitive in terms of the key audit matters and has many peculiarities and prevailing topics for the reason of nature of activities being very different from all other business sectors. The goodwill and intangible assets related matters were found to be the most common in the industrial sector or manufacturing than in others. They usually have on the balance sheet the intangibles like brands, which are difficult to measure numerically, research and development processes, patents, long-term rights, which all are subject to judgement during the valuation process, and auditors have to control and perform audit procedures for all these processes performed by managers. In the reports of energy and resources companies, revenue recognition was very frequent, which is due to billing structure and the difference in time between the payment by the customer and actual delivery of energy to them. It was found that in trade, especially in retail sector and wholesale, key audit matters related to inventory occurred more often than in other industries. For real estate, quite expectedly, property and tangible assets related matters are more common than for any other industry (Audit Analytics, 2019). Some topics, however, are more or less uniformly distributed and do not pertain to a certain industry. These are, for example, taxation related matters, that are present in reports of the companies belonging to all the industries, of course having some special features relating to different taxation regimes and requirements depending on the sectors and country. The question if the same topics of key audit matters tend to repeat every year is valid. In fact, it can be seen that the data analyzed in different researches made of audit reports prepared in 2017 and 2018 was quite recurring. All in all, we can make a conclusion that the key audit matters go in line with the key activities of the companies, therefore the difference arises from that as well as from the most sensitive to judgement areas and those being material and significant.

There are definitely the challenges for all the involved parties in the preparation of key audit matters. The audit standards are not very easy to understand, so as financial statements and audit process itself. The information asymmetry between auditors and readers of reports was aimed to be reduced by the authorities introducing the new standard. The first years of implementation of any new standard, are surely the most difficult, in particular for the auditors in terms of that, since the best practice is not yet well-established, and the new standard allows for a certain degree of judgement. Even more, the doubts about the concept and what it serves for still exist and the authorities try to clarify certain tough points for the stakeholders and auditors. It should be noted that 2017 is the first year in which key audit matters requirement

could be seen in the report and therefore it is not very much time available for perfect understanding of the standard and ideal analysis. The selection of the key audit matters can be difficult, especially if the matter is not in the financial statements. Also, it may be a challenge for auditor to present the key audit matters in a clear and understandable for readers of the audit report way, avoiding too specific technical words, but still keeping them up to the point. The time of preparation and review of the reports are increased; therefore, the auditor and audit committee should involve in early engagement and strictly stick to the deadlines. The interaction, which becomes necessary and more regular, between the auditor, audit committee and management of the audited company complicates the process and makes it longer too (Deloitte Italia, 2018). Another challenge, noted by American representatives in the Deloitte review in the USA, is that the matters in time are likely to become similar among companies especially in one industry, so the main goal of providing entity-specific report might not be achieved. The fears of boilerplate reports are being expressed regularly. However, even if the same topics are being reported, it does not mean that the report will not bring informational value. The circumstances, which led to a certain issue to be considered a key or critical audit matter by the auditor may vary drastically and the audit procedures performed too (Deloitte USA, 2019).

Even through there are guidelines for auditors on the process of selection of key audit matters, the certain level of judgement is being applied. This is in fact one of the most often mentioned arguments, that in the end the decision is made by the auditor and the reasoning may be prone to various, not always objective and pertaining to the audit process only, factors. Pinto and Morais discussed the importance of factors that influence auditor's tendency to act in one way or another depending on the characteristics of company and circumstances of the audit performed (Pinto and Morais, 2018). In France, in the research of Mazars auditors explained 85% of the key audit matters selected as highly prone to management's judgement in the choice an accounting method and in valuation of an account in the financial reports. Auditors there also expressed the importance of materiality of the account or certain area and its possible consequences (Mazars, 2018). Also, the characteristics of the auditor may influence the key audit matters selection process. The auditor is facing a trade-off between the client and the exposure probability, meaning that auditor has to balance between the chance of litigation, reputational loss and the chance of losing the client. Auditors may either avoid disclosing certain key audit matters or disclose an exhaustive list of them. Not all of the insider information can be disclosed without authorization of the management of a company according to the duty of the confidentiality. Ferreira and Morais in their analysis of relationship between company characteristics and KAMs believe that the relations between the auditor firms and companies

being audited is very important during key audit matters preparation (Ferreira and Morais, 2020).

Transition to new standards has been an important part of debate around key audit matters. The introduction of IFRS 9 ‘Financial instruments’ and IFRS 15 ‘Revenue from contracts with customers’ standards were supposed to have an impact on the key audit matters in the audit reports of financial statements of 2018 and further. IFRS 16 “Leases”, effective from 1 January 2019 is the next standard, which is expected to introduce more complexity too. In general, IFRS standards are not that easy to understand and implement for management, and for audit process they hide additional challenges too.

In the Accountancy Europe research, transition to IFRS 9 was reported as a separate key audit matter in 24% of the reports of European banks analyzed (19% in 2017). As an example, the valuation of loans and receivable from customers was a key audit matter of the Credit Agricole Italia banking group audit report, because IFRS 9 change was significant in terms of amounts, as well as in terms of controls, valuation models and IT systems. The auditor had to perform audit procedures to verify the adequacy of application of new standard and disclosures description, together with tests of key controls and other procedures (Credit Agricole, 2019).

The preparation for adoption of IFRS 16 will have to be considered further too, especially for audits of certain sectors like airlines or any company that leases considerable assets, such as real estate, equipment etc. In fact, by reviewing the available information so far, it is possible to make early conclusion, that indeed the key audit matters, related to the change in the standards, were reported. For instance, the Italian tire manufacturer Pirelli audit report performed by PWC in 2019 reported adoption of the new IFRS 16 as a separate key audit matter, due to the magnitude of the amounts of right-to use assets and financial liabilities, which were influenced by the new standard in terms of recognition and depreciation. Adopting IFRS 15 was an issue for some companies too. For example, Pirelli’s report also included key audit matter ‘Revenue recognition’ with reference to the note with adopted accounting standards. Due to the high-volume transactions worldwide and the adoption of the standard, it required special attention and audit procedures to be performed, for instance over internal controls for the revenue sources according to the IFRS 15. The audit report of Enel group, an Italian energy company, indicated that the impact of the first-time adoption of IFRS 15 as a separate key audit matter, the company’s equity was about to decrease quite significantly (Pirelli, 2020).

Since the mandatory first year of key audit matters reporting in the EU was 2017, it is difficult to discuss long-term added value of this change to the quality of audit reports. Later

on, it will be possible to evaluate yearly developments and audit findings and have detailed statistics on the key issues for companies. This could be an additional information used by the stakeholders and authorities. Moreover, it could allow benchmarking across industry sector or market, to get a greater view on the quality of financial reporting in the companies.

1.6. Critical audit matters

The United States of America have joined the global trend of a more informative audit report, in particular the Public Company Accounting Oversight Board (PCAOB) quite recently adopted a very similar to the IAASB requirement for audit reporting – critical audit matters (CAM) paragraph. This concept is described in detail in the standard AS 3101 ‘The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion’. It is coming into action later than key audit matters in Europe, being effective from 15 December 2019 for all applicable companies and a little bit earlier, 30 June for large filers. They are required for audits of all companies following the standard AS 3101, except brokers and dealers, investment companies (other than business development companies), employee stock purchase and savings plans, emerging growth companies (PCAOB, 2017). It is in fact the second phase of significant changes of the audit reporting standards in the USA, first being related to auditor tenure and taking effect for financial statements prepared after December 15, 2017. There are certain differences between KAM and CAM concepts, which are in fact sometimes confuse the public and stakeholders. We are going to look at their special features as well as similarities and differences in detail.

On the figure 6, the schematic illustration of steps necessary to select critical audit matters is depicted. While the IASB standard procedure, illustrated in figure 2, prescribed documenting the significant auditor attention matters and providing reasons why certain were chosen as key audit matters, for critical audit matters procedure it is necessary to document matters communicated to audit committee and relating to material disclosures or accounts in the financial statements, following with the reasoning on the inclusion to critical audit matters or exclusion. A critical audit matter does not necessarily have to relate to entire material disclosure or account, a matter might relate only to a component or part of it or even to more than one account or disclosure material to financial statement. The important requirement for the auditor is to communicate the matter, which was identified in the current audit period. PCAOB introducing the requirement followed the goal of extending the simple yes or no audit report and CAM section intends to bring an additional useful information for the users of the financial reports, especially investors.

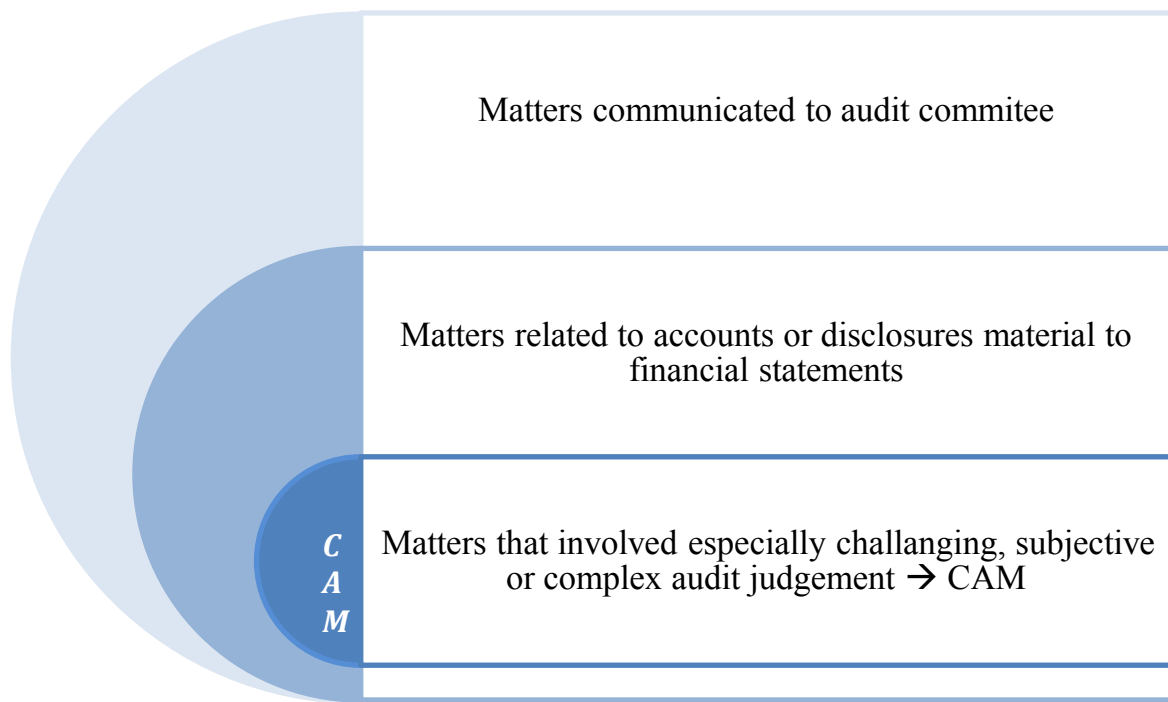


Figure 6. Process of selection of critical audit matters to be reported in the audit report

Seemingly quite similar to key audit matters, critical audit matters are the matters communicated to audit committee that are related to accounts or disclosures material to the financial statements, involved especially challenging, subjective, or complex auditor judgment (PCAOB, 2017). However, the most significant matters requiring audit attention during the audit are not the same as the matters evolving challenging, subjective or complex auditor judgement. Different issues may match one definition and do not match the other, even though they seem quite close in meaning. It should be also pointed out that while the key audit matters place attention on the significant matters for the audit process, the critical audit matters should be connected to the account material to financial statement, therefore it is possible that critical audit matters section would not include all of the key audit matters in the reports of the same company. For instance, implementation of a new IT system may be considered being worth significant auditor attention and communicated as a key audit matter in the auditor’s report but would not be included in critical audit matters because it does not fulfil the requirement of relation to account that is material to financial statement or involves challenging, subjective or complex auditor judgment.

The requirement for reporting also differ in the case of qualified opinion in the audit report. AS 3101 standard applies only when unqualified opinion is issued, while ISA 701

standard does not have this addition. If the auditor expresses adverse or qualified opinion, the critical audit matters must not be reported, while key audit matters can be communicated anyway. Only in case of disclaimer of opinion, the auditor should not report nor critical nor key audit matters (KPMG Canada, 2019).

In order to better apply the definition and to understand what hides behind the ‘involving especially challenging, subjective or complex audit judgement’ matters, PCAOB standard AS 3101 helps in providing the following factors for the auditors to consider while selecting the critical audit matters:

- assessment of the risks of material misstatements;
- degree of auditor judgement related to disclosures involving significant judgement or estimation of managers;
- significant unusual transactions and audit effort, and judgement related to those;
- nature of audit evidence collected;
- degree of auditor subjectivity during audit procedures or during evaluation of the results of these procedures;
- the nature and extent of audit effort addressing the matter, some special skills needed or expert advice outside of engagement team.

However, this list of factors is not exhaustive and PCAOB require to take into account other factors specific to the audit.

The critical audit matters are sometimes confused with critical accounting policies, which is a requirement for management of a company to report critical accounting estimates and new accounting policies adopted introduced by Securities and Exchanges commission (SEC) in the USA. However, they are not similar, and critical audit matters is the audit process related section in the audit report. Some of the critical accounting estimates may be related or reported as critical audit matters, but not necessarily. Not all of critical accounting estimates will involve challenging, subjective or complex audit judgement. As an example, legal contingency may be a critical accounting estimate, but not included in critical audit matters list due to not meeting the above-mentioned criteria (PCAOB, 2017). The same situation is with matters considered to be a significant risk. There is no guarantee that they would be included in the critical audit matters section. It always depends if the matter satisfies the guidelines provided by the standard. At the same time, the sources of critical audit matters are broader. PCAOB issued a guide for investors to explain the critical audit matters concept in a

comprehensible way and answers the most frequent questions asked, in which underlines that CAM do not mean a negative opinion about the company, neither necessarily mean that auditor found a mistake in financial reporting. CAM do not change audit opinion presented in the end of the report (PCAOB, 2019b). In general, it has to be noted that American audit and accounting organizations are providing exhaustive information for many types of stakeholders – investors, board members, audit committee, management etc., explaining the peculiarities of new standard in the smallest detail and answering the frequently asked questions. This informational support is definitely contributing to better awareness of stakeholders about the audit, avoiding confusion in the meaning of the concept and better reputation of audit profession.

The PCAOB requires the critical audit matters to be written in an understandable for the users of reports way, and to summarize the important information for them, rather than describing every detail of the matter and audit procedures performed in response. Similar to key audit matters, they should be entity-specific and as less standardized as possible. The content of critical audit matter description is very similar too. It should contain the description on why it is considered such, refer to disclosures in the financial statements to which it relates, and mention how the matter was addressed during the audit process – the audit approach taken, audit procedures performed in response to the matter and the results of such procedures, as well as other observations that may be relevant in auditor's opinion, The very important point, being highlighted all the time, the same as for KAM, is that auditor in CAM is not providing a separate opinion on the matters or related disclosures, and is not meant to indicate if these disclosures are prepared fairly and in accordance with accounting framework or not. This should not be a long passage, but a rather a summary aiming for a better understanding of a matter in relation to the audit performed (IAASB, 2017).

The key audit matters are a useful tool for effective communication of information to the users of the audit reports, but they cannot be viewed separately from the financial statements and management estimates, but rather to help focus attention to the significant matter and make the audit process clearer for the non-professional readers of the audit report. PCAOB, similarly to IAASB, encourages to use information already disclosed by the company in the CAM section description, but in case it is necessary for a reasoning on why a certain matter is considered a critical audit matter it is allowed. In this case, though, management of a company may include additional description to existing disclosures. That is another reason why close communication between auditor and the company is essential. Apart from audit committee and the management, the board's participation is beneficial too, since they engage with and supervise the process, making sure the investor relations are up to date and ready to answer any additional questions

(Deloitte USA, 2019). The important point is that nor audit committee nor management of a company approves the list of matters to be reported, the matters could be discussed, but the decision and preparation is fully the auditor's duty and someone else's intervention is unacceptable.

The information in the critical audit matters is not as extensive as in key audit matters, due to much recent implementation. However, the reviews of early available data were made. For instance, PCAOB conducted their own review among large filers, which were first in the list to implement the critical audit matters requirement (audit reports of fiscal years ending June 30, 2019). Regarding the main topics of critical audit matters reported by filers, the trend is in fact very similar to the one in Europe, where the goodwill and other intangibles, revenue recognition, taxes and business combinations were four most frequently mentioned matters. However, the average number of matters reported was 1,7 per filer, which is much lower than key audit matters. The year of implementation is 2019, so again, only preliminary conclusions and results can be seen. One of them is the early start of audit teams to prepare and draft critical audit matters and discuss them with management and audit committee, therefore improving the level of communication between these parties. Regular dialogue between management, auditor and audit committee was an important feature allowing for better quality of critical audit matters preparation. It was noted that even though the new requirement is solely the auditor's responsibility, the audit committee began discussing the possible matters very early and were interested in the high-quality audit report. The ongoing updates on the matters were made reflecting the situations and events happening. In addition, audit firms prepared well for the implementation of the requirement beforehand, which contributed to the quality of critical audit matters reported. They also reported that having experts in tax, IT and other areas as early as during drafting process was beneficial, since allowed for better understanding and description of the matters (PCAOB, 2019).

Deloitte performed a larger review on first results of critical audit matters implementation in the USA among large accelerated filers, which were 52. The average number was quite consistent with previous report, with average 1.8 matters being reported. The critical audit matters were most often reported due to high level of subjectivity in applying the audit procedures to specific disclosures or when the necessary audit procedure is particularly complex for a specific account or disclosure. The topics reported are the same as in previous research – goodwill and intangibles (relating to 35% of critical audit matters reported), revenue (19%) and income taxes (15%). The other topics were connected to acquisitions and related liabilities, inventory, other liabilities and contingencies, as illustrated on figure 7. Moreover, Deloitte

noted that the dry runs were completed together with development of tools and mechanisms by large audit firms. During the dry runs, the first reviews of which matters might be included in the section of critical audit matters were performed together with discussions with management and audit committee or order for every party to be fully prepared for the new standard before the actual date of implementation. It indeed helped in a smoother switch to the new requirement and being aware of possible challenges in advance for the involved parties (Deloitte USA, 2019).

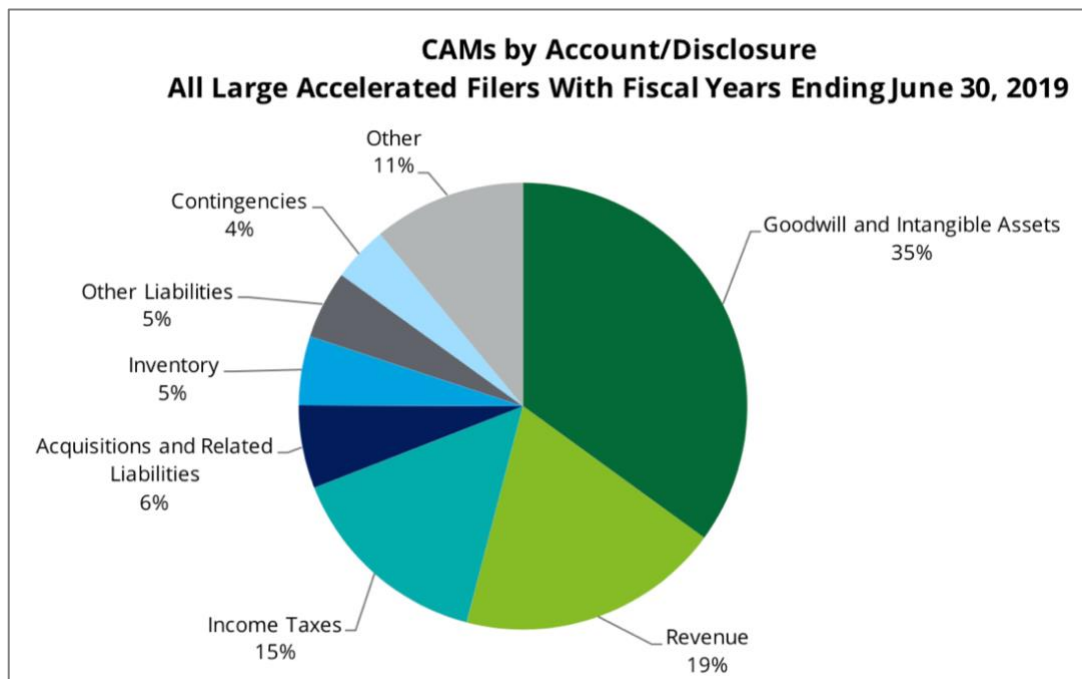


Figure 7. Main topics of CAMs according to the Deloitte review in the USA

Krall Ussery performed the analyses too, showing nearly identical results to the previously mentioned reviews considering the topics and mean number of matters reported, at the same time highlighting the differences between the average matters reported by the biggest audit firms (the Big Four). Out of 50 reports, 13 were prepared by EY, showing the higher average by the report – 2.7 matters, followed by KPMG (13 reports) and Deloitte (10 reports) - 1.7 and 1.6 respectively, and PWC with 1.2 matters in average among 9 audit reports. This is a trend that should be looked upon carefully in future, since it may indicate different reasons such as difference in the audit approach and auditor judgement (Accounting Today, 2019). However, the key audit matters practice in Europe shows that it may be the fallacious assumption with other factors being significant such as industries of firms being audited by firms. Anyway, this is the point to look into in the future. With regard to the perceptions of users of auditor’s report, they usually found the accounting disclosure less reliable and doubtful if the critical audit matter concerned it (Kachelmeier, Schmidt and Valentine, 2017). This is another point requiring

further investigations, since the presence of critical audit matter does not necessarily mean it was prepared by managers in a wrong way.

As an example, from the audit reports reviewed so far, a large filer Microsoft has a lot of customer agreements to purchase software products through volume licensing programs. Since it is not that easy to calculate and recognize revenue for a certain period, and the audit effort to evaluate compliance with standards is quite significant, revenue recognition is a critical audit matter reported. For another large filer, News Corp, international mass media holding, EY included impairment of goodwill and intangibles, since the amount of these assets in the balance sheet are huge and the estimates of their value are often quite complex and arguable, therefore in this case, significant amount of audit effort is put into the process. The certain topics of critical audit matters may be expected to pertain and recur in particular business area or industry, quite similarly to key audit matters. The examples are the allowance for loan loss in banking industry and liability reserves in the insurance sector as recurring matters being specific to these industries (Deloitte USA, 2019).

The study of Christensen, Glover and Wolfe performed among non-professional American investors found that in presence of a critical audit matter investors are likely to change their opinion and investment decision compared to standard audit report or to the same matter being reported in the footnotes. Therefore, they discuss and do not deny the quite firmly present informational and source credibility effect of critical audit matters. However, they concluded that in presence of critical audit matter related of uncertainty around fair value estimates, the investors are less likely to invest in the company than those who saw a report without this matter reported by auditor or with the same matter being included in the financial statements' footnotes. This means that auditor's in their selection of the matters process can be, for example discouraged by the management to disclose those in fears of that. Fair value disclosures in footnotes were mandated by FASB and IAASB in order to provide a clearer picture of complicated fair value estimates for the investors, therefore this study wanted to compare the investors' reactions to this section in financial statements and to the critical audit matters section in the audit report. They concluded that inclusion in the CAM has a stronger negative effect on the investors' propensity to invest in an audited company. The limitation of the study was that non-professional investors, in particular business school graduates took part in the research. Moreover, they concluded, after an additional step of the experiment of adding resolution of the matter, that this influence disappears, and the critical audit matter communication do not result in withdrawing from investing. Moreover, it confirms that the communication of CAM has a

certain amount of influence on the investor, which gives understanding of the additional value of the section (Christensen, Glover and Wolfe, 2014).

To conclude, American experience with the critical audit matters requirement introduction seems to be quite similar to European so far. However, since it is only the first year of actual implementation, it is early to make firm conclusions and further results are needed to make a proper comparison. Moreover, even though it is possible that certain matters are identified as both key and critical audit matters for the same company, there may be differences and some matters may not overlap or be reviewed by auditor in a different way, since the definitions do not completely match and generally speaking the key audit matters constitute a broader concept, since they do not have to relate to particular disclosure as the critical audit matters.

1.7. Key and critical audit matters in the banking industry

The banking industry and banks are key players in the market and are fundamental for the financial stability and economy in general. They are included into public interest entities (PIE) according to the EU regulations. The stability in the banking sector and trust is crucial for normal functioning of the world. The notorious episodes of bailing out banks in order to avoid a clash of financial system, given the performed audit reports of financial statements, which did not find internal weaknesses of the reporting of those banks, gave a new perspective on the financial reporting and audit process. In Italy, the banks play an even more important role for the society, being lenders for the small and medium Italian enterprises, which drive the Italian economy, but do not have access to as many different sources of financing as for example in the USA. Authorities have been looking for the ways to improve transparency and quality of the reporting, as well as let the society and investors trust auditors again, especially in the financial sector. Key audit matters are one of the contributing measures introduced by IAASB together with introduction of the new structure of audit report, and further adopted by almost all EU countries and it is being constantly reviewed how exactly key audit matters influenced the situation concerning banks (Loew and Mollenhauer, 2019).

The banks are presumably more sensitive in terms of key audit matters, and due to high complexity of banking operations the number of these matters may be higher than in other industries. Financial reports of banks are longer and more complex, also due to the more supervision hanging upon them and more complex accounting standards. The high importance of these institutions for all the economies and the high level of compliance to strict requirements

together with specificity of the operations make banks and financial companies stand out among all the others and be analyzed thoroughly by the auditors.

In the new research of Accountancy Europe conducted in 2019, of 62 auditor reports of main European banks, the mean number of matters is indeed higher than in other industries – 4.4 matters in 2017 and 4.2 in 2018. Another study by Mazars in France, Netherlands and UK in 2018 similarly confirmed that banking and insurance sectors had more key audit matters reported than other sectors analyzed (Mazars, 2018). The higher number may show certain peculiarities, however the difference with other industries is not very drastic and the main features of the banking industry can be understood better by looking at the main topics covered in KAM. The topics pertaining to the majority of companies in other sectors like goodwill and revenue recognition are not the top ones in the financial sector, as may be seen on the figure 8.

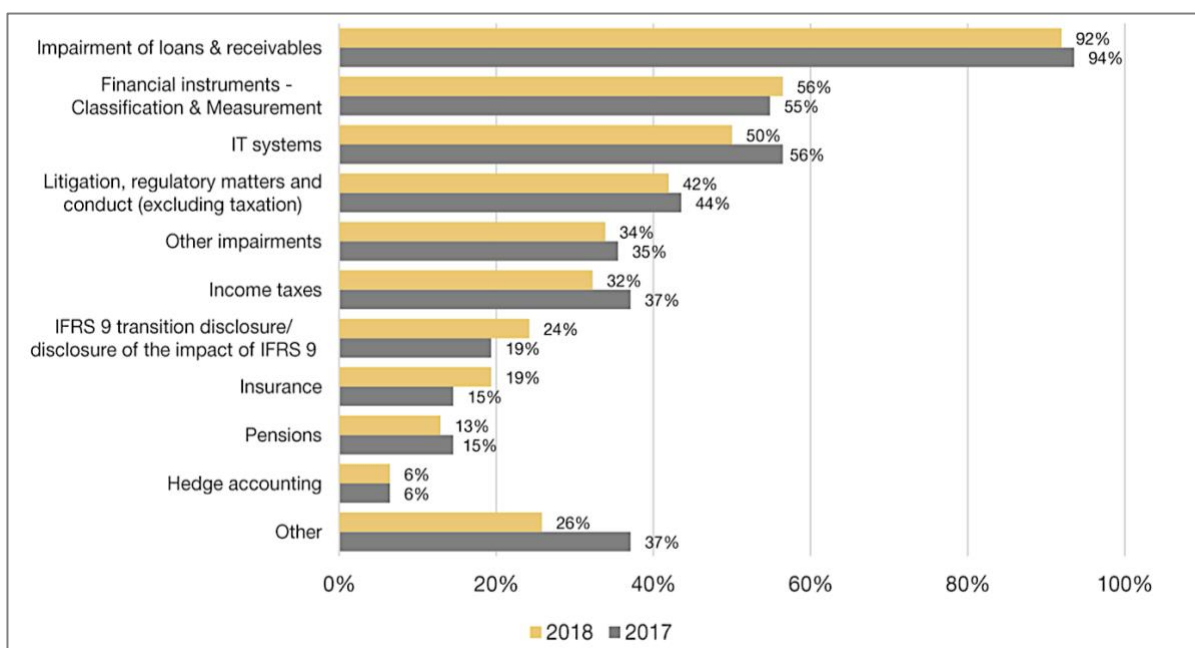


Figure 8. Main KAMs topics, in % from total numbers of reports of European banks

Concerning the main topics there, the most often mentioned key audit matters (accounting for nearly half of all populations), were related to:

- Impairment of loans and receivables – appeared in 92% of the audit reports reviewed.

Impairment of loans and receivables is not surprisingly one of the most recurring key audit matter in banking industry, since the amounts of loans are considerable and the calculation of the impairment is not always intuitive, especially with the application of IFRS 9 and expected credit loss model. The considerable amount of management judgement that may be involved

and the influence it could have on the accounts are the checkpoints for the auditors to look at, and they are not easy.

- Financial instruments (classification and measurement) – appeared in 56% of reports and seems to be quite specific for banks.

The financial instruments account has usually considerable amounts on the bank's balance sheet and it is often subject to strong management's assumptions. In consequence, even slight changes or manipulation of the assumptions can influence the numbers significantly. That is why auditors specifically emphasize matters related to financial instruments in the banking sector. Among financial instruments related matters, valuation of those at fair value were the most common. The financial instruments, measured at fair value level 2 and 3, so not using observable on the active market information, but usually based on valuation models, are prone to managements assumptions about inputs as well. Also, sometimes it is not very clear if the model should be level 2 or level 3 and management may be incentivized to assign a level that is perceived as more reliable, since the models to calculate fair value are sometimes also quite complicated and tailored to each bank or quite often created from scratch, therefore audit procedure to be performed require substantial effort and frequent communication with management. The financial instruments category was quite important also due to transition to IFRS 9 'Financial Instruments' standard as of January 2018. Before the introduction of the standard, the classification and measurement of assets was less often mentioned as a key audit matters, since the complexity of transition to the new standard added more assumptions and new models into the process of financial reports preparation and more work for auditors in relation to analysis and verification of the way these changes were performed in the bank. In general, for the banking industry being so heavily regulated, any new standard implementation is potentially a difficulty and even during audit process too due to initial uncertainty of implementation and special attention to the transition happening.

- IT systems – mentioned in 50% of audit reports. This category shows us the big importance of IT in the banking sector nowadays and mostly were related to internal IT control and user access issues.

Information technologies related matters are present in many industries, nevertheless in banking are one of the most common matters due to the high level of importance of integrity of data in the systems and error-free functioning of the IT systems of the banks. It was proved that especially larger banks, with more assets on their balance sheet are found to be more often communicated in the auditor's reports about IT related matters. This is due to the increased business complexity, these banks usually have more than just classical lending services, they

might offer brokerage, wealth management, securitization and many other possible services in various financial business areas (Loew and Mollenhauer, 2019).

The taxation matters such as deferred tax assets, where auditors have to look at their recognition procedures; legal provisions and litigation related, that often require special expertise for the audit to be performed; insurance matters, most often related to actuarial assumptions; valuation of pensions – all these were the other frequent recurring categories in 2017 and 2018 among European banks (Accountancy Europe, 2019). In the study by Loe, Edgar and Mollenhauer among 90 European banks, a similar trend was confirmed, with top-5 most often mentioned topics in the following order: loan loss provisions, fair value of financial instruments, legal provisions, IT matters and taxation. These categories represented 67,5 % of all 309 key audit matters analyzed. Interestingly, the same research found that the larger banks report more key audit matters, which is quite logical since the complexity of these entities increase and the audit process required for them becomes more challenging. Concerning the taxation matters, the already mentioned deferred tax assets were found to be quite significant particularly in countries like Italy, Spain and other southern European countries due to the acute situation during the last financial crisis and in consequence currently large amounts of non-performing loans on their accounts. The problem is that it is doubtful that these banks will perform well enough to recover the deferred tax assets existing due to their considerable amounts. Therefore, for them the key audit matters related to taxation is expected be especially common (Loew and Mollenhauer, 2019).

Deloitte review of key audit matters practice in Italy confirmed the similar trends among financial institutions, explaining that accounts receivables and loans were the most frequent category, often connected to the non-performing and high-risk performing loans due from customers. Italian banks have significant amount of domestic loans on their assets side of the balance sheet, therefore the issues connected to measurement of loans from customers are quite common. The remarkable proportion, around half of all key audit matters related to accounts receivables and loans, were found in the reports of financial institutions, while other half pertained to all the other reports from all other different industries. To note, the analysis was performed on 221 auditor's reports of Italian, listed on the MTA, companies, 28 of which were in the banking industry. The significant amounts of receivables and loans from customers in balance sheets of banks as a general banking feature is a factor contributing to this trend, together with a quite complex estimation processes and valuation models used. Moreover, it is claimed that in Italy special focus is on the impairment of non-performing loans and the losses connected to that. Respectively, the audit procedures performed in response to these key audit

matters were the testing of operating effectiveness of controls together with a review of internal controls of banks in terms of monitoring the quality of loans and receivables from customers. Furthermore, experts were involved into the procedures also relating to the IT systems used by banks, which are normally quite complex, and the valuation models, which can be also complex and customized for a particular situation. Apart from the receivables and loans category, provisions and contingencies such as for possible risks such as legal or tax issues, were weighted significantly in the banking and investment management sectors. These sectors are regulated differently from others and much stricter and in consequence the compliance, legal, reputational or other risks are more acute for the banking and financial institutions. Therefore, no wonder there are significant numbers of key audit matters reported in the auditor's reports of this kind of institutions (Deloitte Italia, 2018).

Moreover, the Mazars research performed in 2018 and 2019 showed the general trend that key audit matters topics recur in the reports and therefore are quite consistent among banks in Europe within the time. Of course, there are certain circumstances and events that cause one-time communication of a key audit matters. It was also found that, where applicable, so in most cases except information technology related key audit matters, the key audit matters were clearly linked to financial statements disclosures – cross-referenced – therefore providing greater understandability for readers. The more meaningful reports were presented with the introduction of key audit matters, especially noted by investors, which are on a large basis responsible for the stability of the financial system and markets in general. The analysis of similarity of texts of the key audit matters covering certain topics showed that the key audit matters sections in the audit reports of the European banks in general did not contain standardized wording and that the text prepared by the auditors were quite specific (Loew and Mollenhauer, 2019). All in all, the key audit matters requirement in banking industry were considered valuable for the stakeholders of banks and for the banking system in general. Since the financial sector and banks in particular serve an extremely important functions and require high transparency and low information asymmetry, key audit matters standard is especially relevant for this sector. Accountancy Europe survey in the European banking sector confirms that the auditors respond to the stakeholders' request for more informative reports and in the stakeholder's opinion in this way increase the financial stability. Communication of key audit matters was met positively by the stakeholders of the banking institutions, especially investors (Accountancy Europe, 2019).

1.8. The critique of key and critical audit matters

There are controversial opinions and debates, which happened around key audit matters requirement before and after implementation. Some have been skeptical about the introduction of key audit matters requirement and frequently point out the auditor liability related consequences. In other words, auditors may be tempted to use key audit matters paragraph as a way to decrease their own liability by creating an exhaustive list of matters. However, Gimbar, Halsen and Ozlanski stated that this point was not proved by any evidence after key audit matters introduction (Gimbar, Halsen and Ozlanski, 2016). Similarly, there was a controversial debate around auditor legal liability described by Gold and Heilmann in terms of perception of court and litigation issues in a case of undetected misstatements, being more acute in the United States (Gold and Heilmann, 2019). Moreover, the confidentiality duty, which is an obligation of not disclosing information to the outside parties without proper permission unless there is a legal or professional right to do so is another factor, which can potentially decrease the usefulness of the key audit matters and complicate the work of auditors. If the auditor discloses this kind of information, they can lose the client, so they have to be more attentive.

It is also mentioned that key audit matters may take all the focus from other parts of financial statements, since key audit matters paragraph is concise and more understandable than many parts of financial statements consisting of dozens of pages. This study by Sirois, Benard and Bera in 2018 found that communicating additional sections with new information decreased quality of audit perceived by the readers. The eye-tracking study reported that the key audit matters has its benefits such as informational, as well as the costs such as taking more attention from some other important parts. Therefore, the concept cannot be perceived as a purely positive change. However, it must be noted that this study had limitations and included accounting students as participants, not the actual stakeholders such as investors, directors etc. (Sirois, Bédard and Bera, 2018).

And as it was mentioned before, there is no guarantee that the paragraph will be written in an understandable way for readers, therefore fears that 'carefully drafted from a legal point of view' report would be prepared (ACCA, 2018). Additionally, there were fears of the situation by Boolaky and Reiner, when positive influence of key audit matters will be evened out by other facts, which point out to risks and uncertainties giving negative impression to public (Boolaky and Quick, 2016). Another critique by Bédard et al. was based on the assumption that since key audit matters are supposed to be based on the already disclosed by the company information, the actual usefulness of the section is not justified. There is the opinion that the

new auditor's report and introduction of key audit matters has a more symbolic and reputational value for the audit profession and market trust (Bédard, Chtourou and Courteau, 2004). In addition, the readability was found to be rather low in the analysis of Fog-Index, which is the index that shows the level of difficulty reading the text in the years of education needed in order to fully understand it. The key audit matters section had higher difficulty level than the annual reports, meaning that readability of the section is not that easy, and the expectations of the authorities are presumably not fully met (Loew and Mollenhauer, 2019).

In general, there was a number of fears before the implementation of the changes and still the certain level of skepticism around the matter exists. Nevertheless, majority of published reviews, also mentioned before, were approving the change and discussing how valuable they are for different types of stakeholders of companies. Even through the impact of the key or critical audit matters section on the stakeholders' decisions is arguable and is still being investigated, these sections are definitely drawing attention of readers of the auditor's report on the matters described. Especially if the section is prepared in intended way, concisely and visually plausible, the attention will be drawn.

It can be argued that any additional information or important issue, including those concerning the implementation of new standards or switch to different one, should be covered in notes, or sometimes called footnotes, to the financial statements in annual report of the entity and that they serve a much more important informational role than key audit matters paragraph. In reality, such information indeed can be included in the annual reports, for instance banks and other financial institutions explain in the notes the transition to IFRS 9, 16 etc. However, the opinion expressed by Asbahr and Ruhnke, that the key audit matters are, first and foremost, matters provided by the independent party - auditor, that are the most significant for the audit of the company, while notes just provide some other information on accounting disclosures that managers may find relevant for readers, therefore prepared by the insiders of the company. Notes are definitely serving an informational role for the users of financial statements, but they do not possess the same level of credibility as the audit report, prepared by the trustworthy audit firm with reputation that it wants to maintain. The topics covered may be similar, but the presentation and credibility levels differ (Asbahr and Ruhnke, 2019).

. Saying that, footnotes are usually longer and much more descriptive than key audit matters paragraph. The objective of the key audit matters paragraph is to be concise and clear for readers. Christensen, Glover and Wolfe affirmed that the American investors are expected to be influenced more by the critical audit matters paragraph than by the management's footnotes section too (Christensen, Glover and Wolfe, 2014). It was also found that professional

investors, who are those that trade large amounts of shares, in general pay attention to the footnotes disclosures, but it is doubted that nonprofessional investors pool do that, considering the volume and often complicated description of the models used in the footnotes (Cade and Hodge, 2014). Therefore, the roles and credibility of footnotes and auditor's report differ, though both very important for all the stakeholders.

1.9. The COVID-19 impact on the key audit matters reporting

Concerning the extraordinary situation with COVID-19, it had and is still having quite significant impact on the companies' operations, financial reporting and in consequence on the audit reporting in general, both in the USA, Europe and other regions. This includes the changing dynamics of the key and critical audit matters sections reported too.

The situation with the key audit matters in audit reports of European companies changed due to the COVID-19 pandemic. Audit Analytics review from 2019 reports and partial year data from 2020 highlighted the increase in the average numbers of key audit matters reported in Europe, attributable to the COVID-19 pandemic. This is quite in line with the expectation that some key audit matters would be considered as such because they require significant audit attention also due to the pandemic influence. Among European companies reports, the biggest number of key audit matters related to coronavirus pertained to the small capitalization companies (under 100 million euros), which are the most vulnerable ones in this extraordinary situation. Particularly, the finance, insurance and real estate industry companies were found to capture 30% of all key audit matters communicated related to the pandemic impact. The going concern related key audit matters appeared significantly more often than before, as well as the emphasis of matter containing COVID-19 as an important factor for understanding the financial statements of the audited companies due to its significant effect on certain accounts. Even going concern audit opinion modification were reported more often, where the uncertainty about future of the entity is expressed. These are the first results available, and it is clear that this situation has a potential to significantly influence the future of some companies, and more often not in a good way, though the real long-term impact on the companies' operations, audit processes and reports is further to see with the development of the situation in the world. The financial statements and audit reports from 2020 are going to provide us with the further effects of the events on the companies (Audit Analytics, 2019).

The impact of COVID-19 pandemic on the economies and businesses is huge all over the world and since it is not over yet no one can estimate and predict the final consequences,

which brings additional difficulties to that. The markets expect from the audit reports this year an even increased level of transparency regarding the impact of pandemic on the entities and financial reports prepared. The disclosures, which demonstrate the changes due to possible interruption of activities, government actions, closure of borders, market crash and many others, and the calculations of sensitive accounting estimates are those that will be scrutinized by the users of the reports and those that require special audit attention. The impact of COVID-19 pandemic may influence the audit process and the procedures needed to be performed with sensitive areas being those where significant judgement of managers was applied. The fact is that the COVID-19 added more uncertainty to everything and auditors have to deal with this uncertainty in order to provide a reasonable assurance for the users of the auditor's report. The material uncertainty related to going concern will definitely be much more present in the reports, since the risks are much higher, and the auditor will have to prepare convincing audit evidence related to the going concern. It may be necessary to issue a modification to the auditor's opinion too in some circumstances, in particular when the sufficient appropriate audit evidence was not obtained. IAASB issued a special alert for the auditors concerning the audit report and key audit matters, in particular related to difficulties arising during the preparation of audit evidence and special events or transactions. Due to the pandemic some audit evidence may be harder to get as well as to perform audit procedures especially concerning the valuations of financial instruments and fair valuations. Auditors are forced to perform the audit process in a different environment using different methods, working online and using the tools not used before. The once-off transaction such as impairments of assets could also influence the matters to be included in the key audit matters. The complexity that pandemic impact may add to the estimation uncertainty around disclosures or accounting estimate may be the determinant factor in dedicating significant audit attention and effort to that during the audit process, and as a consequence the classification of the matter as a key audit matter. The circumstances in which modified opinion is released as described in ISA 705 (Revised) or the significant going concern doubts are in place as described in ISA 570 (Revised), auditor should not list those as key audit matters, but rather make a reference to the corresponding parts of the audit report, e.g. to the Basis for Adverse opinion or Material Uncertainty related to going concern sections respectively. Concerning the emphasis of matter section, it is mentioned that the auditors should be careful in adding this section into the report due to risk of reduction of effectiveness of such communication in case of a widespread application. The emphasis of matter section should be included in case when the matter was not considered a key audit matters, and the opinion was not modified, and the matter is not focused on the material uncertainty related to going concern. It is just an additional measure used to point to a matter presented in the financial statements

and attract special attention of the users of the report to it, in case it was not listed as one of the key audit matters, but the auditor still considers the matter as a fundamental for the understanding of the financial reporting. The reasons for considering the matter fundamental and worthy of an emphasis of matter paragraph should be mentioned as well. In the absence of such, the matter could be included in the other matters section (IAASB, 2020). Key audit matters are of particular importance during these hard times, since they are showing which issues required significant attention from the auditor and with this giving the additional information about the risks and sensitive areas in the financial statements. However, it should be kept in mind that having more key audit matters is not a bad sign or abnormal event and they do not change the audit opinion expressed.

Concerning the situation with the audit reporting in the USA, the Centre for Audit Quality, which is the non-profit organization supporting trust in the audit and reporting in the USA, noted that due to tough economic conditions many companies may face uncertainty about their operation as going concern. Therefore, if the auditor concludes that there is a significant doubt of future of a company as a going concern, the special paragraph, explanatory language as prescribed in AS 3101 standard, is required to be included in the audit report together with the critical audit matters, since they cannot substitute the special explanatory paragraph in this case. In this case, the reference to that paragraph is made in the critical audit matters section. At the same time, if auditors decide to describe a matter in both sections anyway, it is allowed too, but the cross referencing should be done. The emphasis of matter paragraph is not required to be reported and does not substitute any other section, but it can be included, for instance when it can be presumed that management is able to deal with the going concern problems and mitigate the risks, but auditor still wants to highlight the significant matter.

In addition, it is noted that the COVID-19 pandemic itself would not necessarily be considered a critical audit matter, but it may accelerate the level of complexity of audit process in general and change the way the CAM are addressed during the audit process. The matter should be necessarily related to account or disclosure material to financial statement to be considered as such. But for instance, some matters would be considered critical audit matter mostly due to the COVID-19 and its consequences, and otherwise they would not be considered as such under the normal conditions. Also, it is believed that previously communicated matters would probably expand due to the COVID-19 and require new audit procedures to be completed in response (The Centre for Audit Quality, 2020). The topics previously frequently reported namely goodwill and intangibles, revenue recognition, business combinations and taxes are expected to be present even more often, given the complications to the processes and audit

procedures related to these topics introduced by the COVID-19 situation. The important remark is that CAM requirement goes into effect after December 15, 2020 for other applicable companies, except large accelerated filers for which it started being effective earlier. Therefore, smaller filers are supposed to implement the new requirement together with additional uncertainty added by the pandemic, which may to a certain extent complicate the process of implementation. However, the close interaction between the audit committee and auditors and dry runs should prepare the management and stakeholders for what to expect from the critical audit matters reported.

CHAPTER 2. ANALYSIS OF IMPLEMENTATION OF KAMS AND CAMS ON THE EXAMPLE OF BANKING INDUSTRY

2.1. The aims and methods

So far, the theoretical background and previous research on the key and critical audit matters as well as current trends and highlights were reviewed and discussed in detail. One of the most specific industries were definitely the banking industry. The banks are the institutions of high importance to all the economies in the world that handle complex procedures and operations, at the same time being subject to very strict regulations everywhere. The key and critical audit matters in the reports of these entities have special features and present particular interest too, as we have already seen. In the next chapter of this thesis we aim to focus on the audit reports of the banks and review them very carefully in order to understand better how the concepts were implemented in practice and make our own conclusions about general characteristics of the key and critical audit matters communicated among banks' reports. By analyzing the key and critical audit matters section of banking institutions, it will be possible to summarize the main topics and issues arising, compare the experience from the EU with American one and find the advantages and disadvantages of different ways of communicating the matters for the users of the auditor's report.

In this research both quantitative and qualitative methods were used. The methods of analysis and synthesis were used to better understand and describe the concepts. Starting working with the auditor's reports of the banks from the sample, the information from them was recorded in the Excel and the banks were sorted by some of the characteristics such as country, audit firm, number of matters communicated, emphasis of matter paragraph presence, experts involvement, tests of controls performance. Further, the content of the matters was analyzed even more in detail in terms of the topics and description of the reasons for inclusion and the issue behind the matter, as well as the type of audit response. The matters were grouped in topics, prevailing among them. The inductive method of reasoning was used to distinguish patterns among the matters. The graphical method of presentation is used in the thesis for visual clarity of the main trends and patterns found. Next, the styles of presentation and the language of communication of the matters are evaluated and compared between KAMs and CAMs. In general, comparison between the KAMs and CAMs in terms of many parameters was performed, on the example of our selection of auditor's reports. The results and generalization gained are further compared with previous studies, which enabled us to provide main

characteristics of the key and critical audit matters among banks with their peculiarities, that auditors and stakeholders should pay attention to.

2.2. Description of sample

Concerning the process of choosing the sample for the analysis, it is worthy to mention that all the banks in the EU have in their auditor's report the key audit matters paragraph, since apart from the ISA standards applicable for listed entities, there is requirement (EU) No 537/2014 in place to report key audit matters for all public interest entities (PIEs), including banks in the EU jurisdiction. It is quite easy to find the auditor's reports of any banks and the choice of banks on this side do not cause any problem. The situation in the USA is quite different, since the requirement to communicate critical matters was much more recent than in the EU, only last year and starting only with large accelerated filers. Therefore, the choice of the banks was limited from the very beginning. According to the U.S. Securities and Exchange Commission (SEC), in order to be considered a large accelerated filer, the issuer, in this case a bank, should have a public float of \$700 million or more, as of the last business day of the issuer's most recently completed second fiscal quarter, apart from other existing rules (SEC, 2020). As a consequence, these banks are usually large, and in order to complete a valid analysis and plausible comparison it was decided to take top 50 large accelerated filers banks by asset size and compare with the top 50 largest European banks by assets. The lists of biggest banks in 2020 by asset size were available online from the S&P market intelligence for Europe and from the Federal Deposit Insurance Corporation (FDIC) for the USA. From the list of FDIC of American banks by asset size, only large accelerated filers were taken, and a list of only large accelerated filers was formed. All the annual reports as well as 10K forms of these banks were found easily online on the each of the bank's website, containing auditor's report. We focused on the auditor's reports prepared on consolidated financial statements. The complete list of the banks in the sample could be observed in the appendices.

To summarize, in our sample there are total 97 reports, out of which 50 reports are of the US banks and 47 reports of the European Union banks, due to the exclusion of the 3 large European banks, belonging to the countries out of the European Union, namely two from Russia and one from Norway. The financial year of the reports was chosen 2019, since it is the latest year having available audited financial statements. To note, the UK was considered as a part of the EU since it was in fact a member still at the moment of the preparation of the financial statements and it is currently under transition period. There were banks of 13 countries in the European Union among the banks selected, which are the largest banks and have particular

significance for the financial industry and stability in the EU. This will enable us to look at the key audit matters reported also across the countries within the EU. On the illustration below the countries and number of banks are depicted. The largest number of banks in the sample belong to Germany with 7 banks in the list, the United Kingdom with 6 banks and France with 6 banks too.

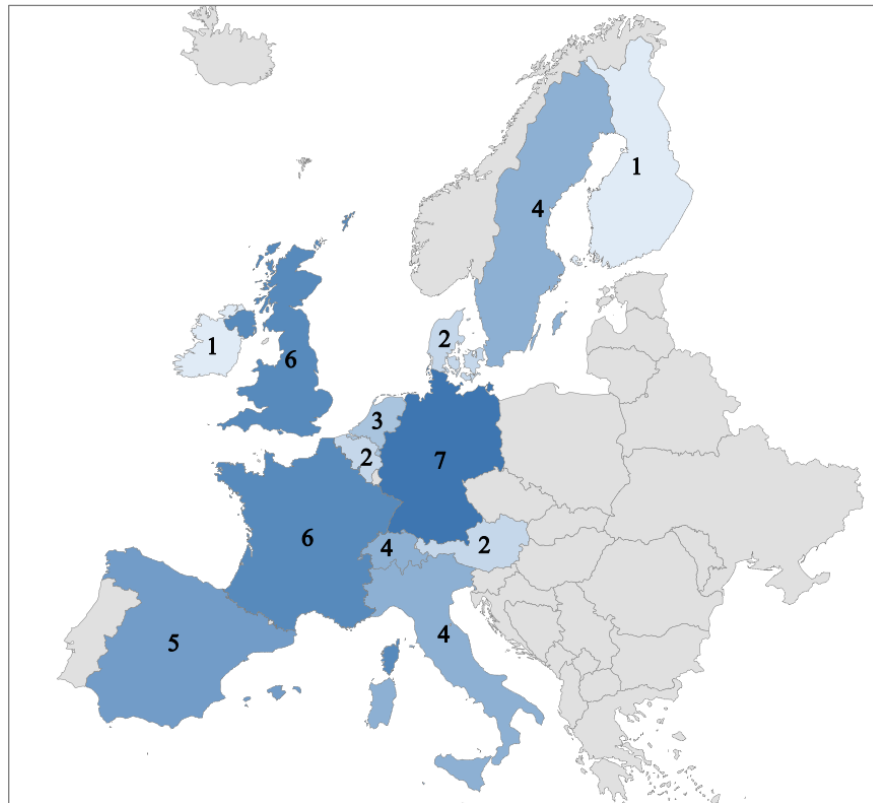


Figure 9. The countries of the banks from the EU in the selected sample

All the reports were found in public access and downloaded together with checking for the critical and key audit matters sections presence, which were quite expectedly present in all the banks of the chosen sample. By looking at the reports, we have the opportunity to see if the results of this analysis match the results from previous research concerning banking industry and make our own conclusions about the key and critical audit matters sections in audit reports from the USA and the EU. The average numbers of matters reported, the main topics of the matters, the ways of communication and presentation of the matters, the similarities and differences between the auditors issuing auditor's reports – all these and many other indicators are found and described in the following chapter. They all give the possibility to compare two similar concepts – key audit matters and critical audit matters and validate the already known characteristics of those as well as find new ones based on the practical review.

2.2. Numbers of KAMs and CAMs

Among 47 reports of the largest banks from the EU, 177 key audit matters were identified. Analyzing the mean number of matters reported, the number was more than three key audit matters on average, precisely the mean value was 3,766 matters per report with median equal to 4. As can be seen from the graph below, the majority of reports had equal or less than 5 matters reported, namely 40 reports or roughly 85%.

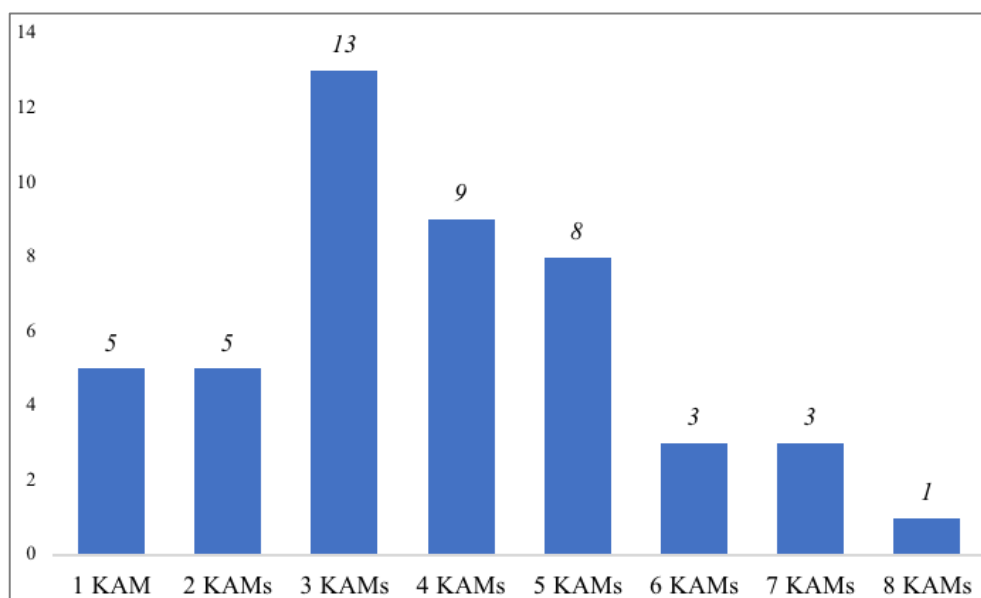


Figure 10. Numbers of KAMs in the reports

The average number is indeed higher than the one found across all industries in Europe, as was before suggested by Accountancy Europe research. In all of the reports there was at least one KAM reported, therefore there were no exceptional cases where key audit matters were not communicated. The Bank of Ireland had the maximum key audit matters reported of all banks – eight matters. Concerning the countries differences, the numbers of matters communicated in the auditor’s reports of banks from the EU by country are illustrated on picture below. Seven audit matters were reported in the three reports, among which two belonged to banks from the UK and one to the Belgian bank. Additionally, we tried to see which banks had more key audit matters in their reports, in order to understand, for example, if bigger banks report more matters than the smaller ones. The top ten banks indeed reported high number of matters, and all of them reported more matters than the mean value except two banks, BPCE having 7th place and only 1 matter and Intesa SanPaolo, having 10th place and 3 KAMs. However, it was difficult to see the clear connection between the asset size of the bank and the number of matters, also due to some significant differences between the countries’ averages, such as UK and Ireland, which normally demonstrated higher numbers of KAMs in the auditor’s reports of the banks compared

to other countries of the EU. Therefore, we cannot make a conclusion about connection of size of the bank and the numbers of matters reported.

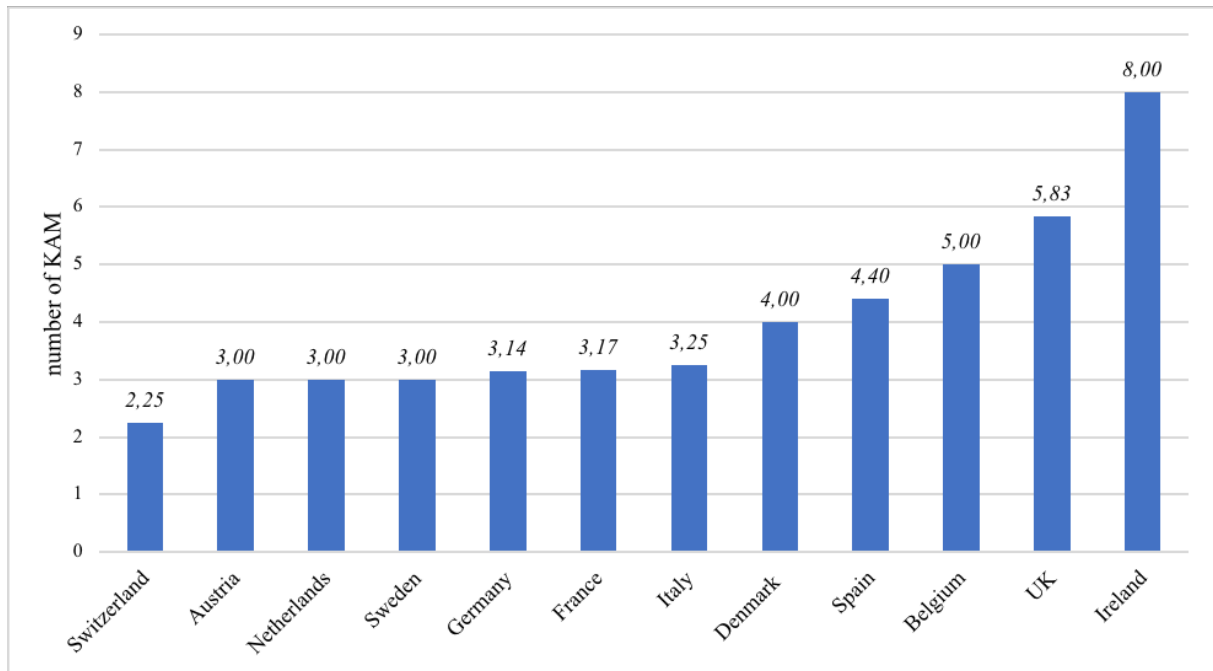


Figure 11. Number of KAMs by country

In general, the differences in numbers of KAMs reported do not seem drastic. As was already mentioned, the only significant difference concerned the reports of the British banks and the Bank of Ireland, since the mean number of matters reported there was the highest of all. This goes in line with previous studies, where the average number of matters in the reports of the companies from the UK was the highest and from our data banks do not seem to be an exception from this trend too. The UK banks in our sample had no less than 4 matters reported and a maximum of 7 matters in the reports of Lloyds Banking Group and Royal bank of Scotland. This was explained as a consequence of accounting complication, valid both in the UK and Ireland because they have the same accounting standard setter – Financial Reporting Council (FRC). The example could be pension schemes, and in fact in the selection of reports 3 out of 6 British banks had valuation of pension related matters as the key audit matters, and of all 7 pension related matters 4 belonged to the banks of the UK and Ireland. In the other countries of the EU pensions valuation presented audit difficulty less frequently than in the UK and Ireland.

Mazars research in Europe suggested that another reason for the higher number of matters reported could be that the auditor's reports from the UK usually had key audit matters on similar topics separated and described in depth each of them instead of combining into one matter. We tried to check if it is indeed true and it is difficult to deny that auditor's report from

the UK are one of the longest and most detailed in general, and there were some examples of separate matters on similar topics. One of them is the report of Lloyds Banking Group, where the insurance related matters were separated into assumptions being subject to judgment and payment protection insurance (PPI) provisions. Another example is in the report of HSBC, where the two different associates of the group were separated into two matters, namely Investment in associate – Bank of Communications Company, Limited ('BoCom') and Impairment of investment in subsidiaries (Parent Company only), while often the Business Combination and valuation of connected businesses related matters are put together into one matter and approached by audit in similar ways. On the other hand, the complications of this unique situation of the given bank's audit process may require this sort of special attention to them as separate matters thus requiring auditor to report these matters separately. Hence it is a questionable argument in terms of higher mean number of matters reported, which should be looked into deeper, probably in the studies of all industries.

The difference in the numbers of key audit matters reported between different audit firms was analyzed too. All of the audits were performed by the Big Four audit firms, with 7 reports being joint audits by several audit firms. Therefore, it was not possible to compare the non-Big Four to Big Four audit firms' data. Previously, the study on the banking sector in Europe did not confirm the idea that different audit firms interpret and apply the key audit matters concept in a different way. On the figure 12 it can be observed that there is no big difference between the number of the matters reported by each audit firm, consequently we can agree with the previous study. The Deloitte most likely shows a higher number to the presence of 7 matters in one of four reports, the one of Belfius Bank from Belgium, pushing the overage number over the general average. Therefore, it is doubtful that certain audit firms communicate more audit matters or approach the KAM concept in a different way.

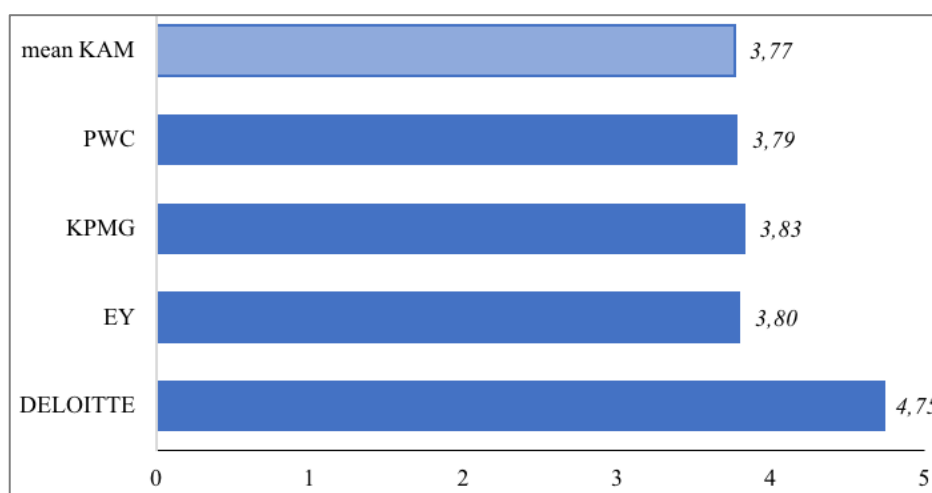


Figure 12. The number of KAM reported by the Big four audit firms

Analyzing the reports of the large accelerated filers American banks, overall there were 76 matters for all of the 50 banks. Concerning the average number of critical audit matters, it was 1,54 matters and the median was equal to 1. All of the reports contained at least 1 matter and the maximum number of matters reported was 4, belonging to the report of Valley National Bank. The mean number of critical audit matters reported was lower than key audit matters, 1,54 mean CAMs compared to 3,766 mean KAMs, thus confirming the trend reported in previous research that compared CAM and KAM statistics. This can be, at least partially, attributable to the difference in the definition, since as was already mentioned the two concepts are not completely identical and a critical audit matter has to relate to account or disclosure material to financial statement, while a key audit matter not necessarily. Therefore, some topics present among KAMs were excluded from the critical audit matters. For instance, IT system matters were not present in the American reports since they do not satisfy the relation to disclosure requirement to be considered a CAM, and they were a third most frequent matter accounting for 12% of all KAMs and indeed being one of the topics of large significance among all KAMs categories for banking industry in Europe.

As a matter of fact, from the following graph it becomes clear that prevailing majority of the reports, namely 90%, contained either one or two matters, and one matter was the most frequent number of CAMs in the 58% of the banks in the sample. Only four reports contained more than three CAMs, namely JP Morgan Chase, Citibank, Truist, PNC, Valley National Bank. More than half of the banks from the EU had from 3 to 5 KAMs, therefore it can be confirmed that there are less critical then key audit matters reported on average.

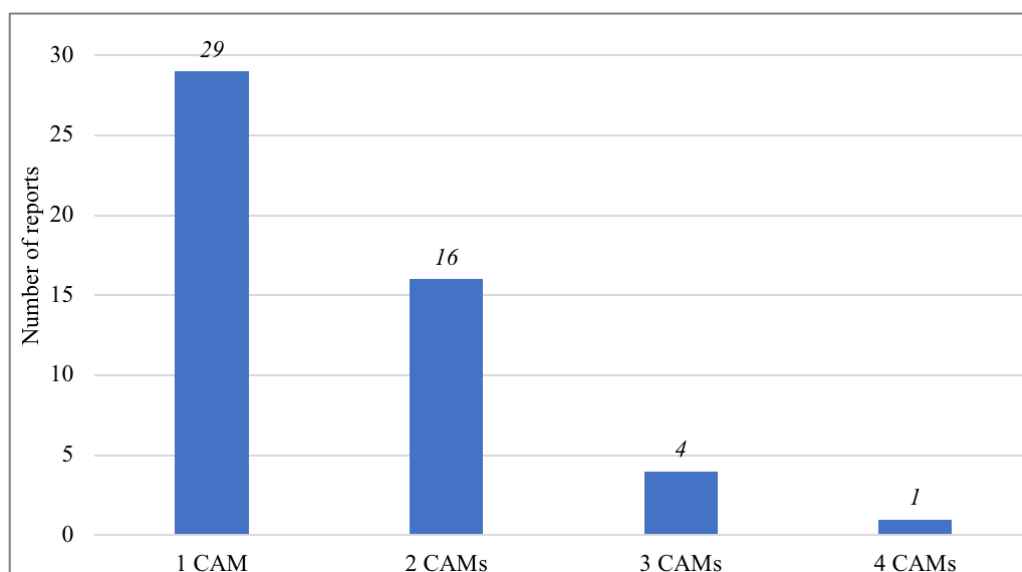


Figure 13. Number of CAMs per report

We analyzed the number of matters reported by the audit firms, and similarly to the European trend, the numbers did not vary significantly, showing values between one and two matters, as depicted on the figure 14. All of the reports were performed by the Big Four audit firms, except the report of First Citizens Bank and Trust Co. done by Dixon Hughes Goodman.

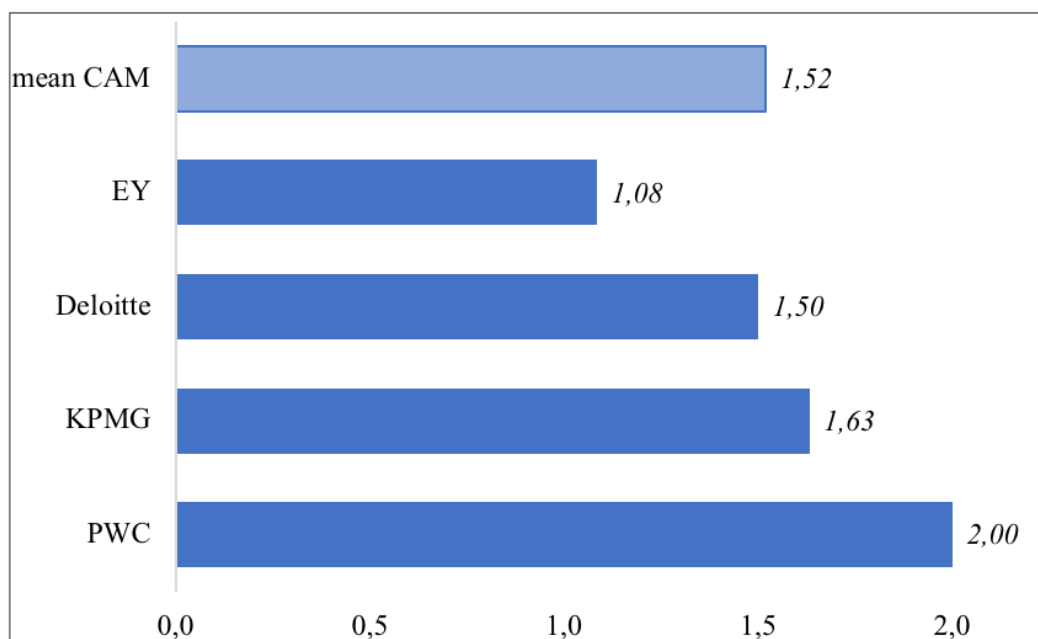


Figure 14. The mean numbers of CAM reported by the Big four audit firms

2.3. Main topics reported

The following step was to perform the analysis of the topics of key audit matters reported. Especially, it was crucial to see whether there are categories pertaining to the banking industry and compare them between banks in the EU and USA. We grouped the matters into common main themes in order to observe which ones were significant during the audit process and required the most auditor's attention and what are the possible reasons for that. In the reports of the EU banks some topics were overlapping, but we tried to emphasize the main features of the matters and unite them into categories, which can be observed on the figure 15, in order to analyze the most and least common topics of KAMs. The top three topics were the following ones:

1. Impairment of loans and receivables, which accounted for approximately 21% of all matters
2. Financial instruments valuation, presenting roughly 20% of all matters
3. IT systems, accounting for around 12% of all matters

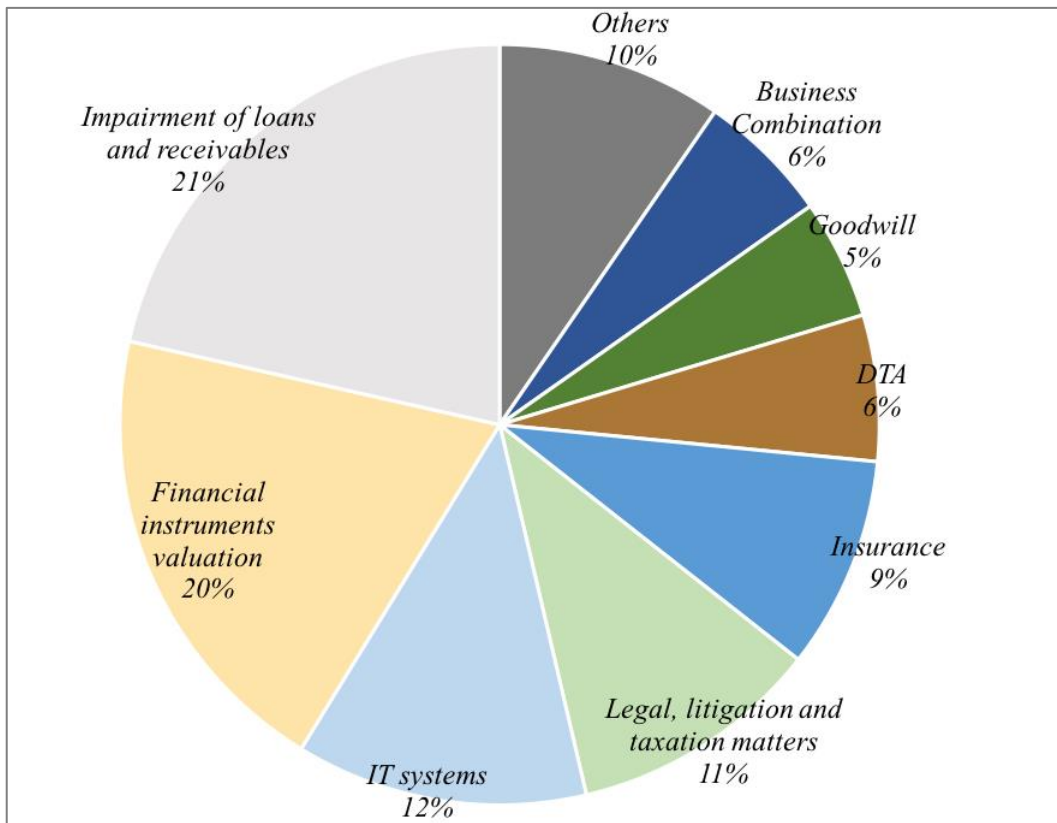


Figure 15. Most frequent topics of the KAM in the reports of the banks in the EU

Not surprisingly impairment of loans and receivables is the number one topic, due to the amounts of the loans on the balance sheets of the banks and the level of judgement involved in the process of estimation of impairment. The matter related to this topic was present in the reports of 38 banks of 47, which is around 80% of the banks in the sample shown on the figure 16, therefore without any doubt this is the category being specific to banking institutions. Discussing the reasons of inclusion of the matter, it is important to mention IFRS 9 standard and expected credit loss (ECL) model. This model and its application by management of the banks represented one of the most challenging issues for the auditors.

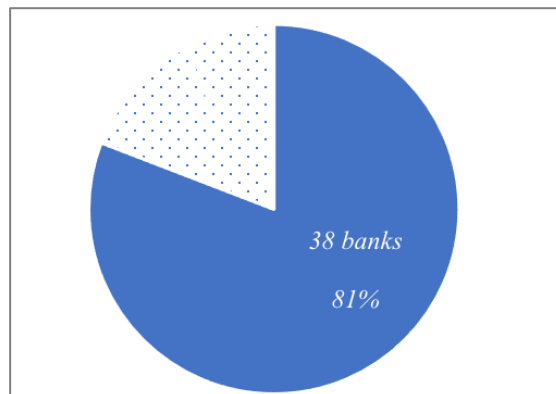


Figure 16. Banks having at least one KAM in the loans and receivables category

There are three stages of loans, and even the staging and transfer from one stage to another involves management judgement in terms of decisions of increase or decrease in credit risk of a loan. The expected credit loss is basically the difference between the contractual cash flows and the one a bank is going to receive discounted at the interest rate, so it is crucial to the bank's profitability since it allows to understand if the money from the borrowers can be returned and how much. The ECL model involves the probability-weighted scenarios, projections of cash flows and calculation of the indicators like probability of default (PD), loss given default (LGD), exposure at default (EAD), which are complex and involve significant judgement. In a case of individually assessed loans, which are the at default and marked stage 3, the decisions on the loan loss amount and whether there was a loss event are highly judgmental too. It is important for the audit that the scenarios, estimations of the indicators, cash flows etc. are verified, justified, performed in a consistent manner and properly documented. This makes the audit process complex for the matter and requires the performance of specific audit procedures to address it. In fact, this category of matters was usually the most extensive because the matters required a lot of audit attention and performing many audit procedures - the tests of controls were performed for all the banks, for example tests of the manual and computerized controls for assessing credit risks and valuating the ECL, and in many cases substantive audit procedures on impairment allowances assessed individually and collectively too. The economic experts and modelling specialists participated in the audit processes very often, as can be seen on the chart below.

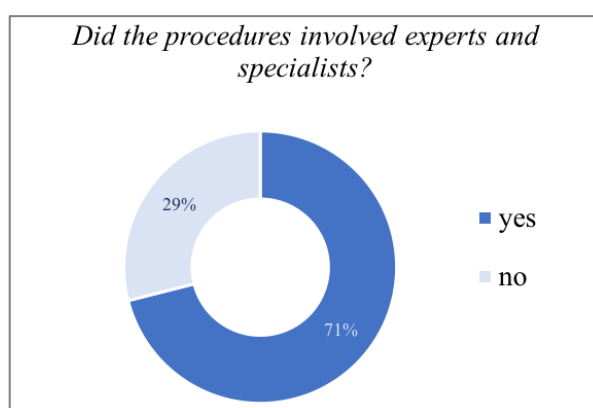


Figure 17. Involvement of experts in the audit procedures of KAMs related to impairment of loans and receivables

The matters belonging to the valuation of financial instruments category were present in the reports of 30 out of 47 banks from the EU, so in the majority of reports. This topic was mostly focused on the fair value valuation of financial instruments, especially level 2 and 3 of fair value hierarchy according to IFRS 13. These are financial instruments held for trading,

derivative contracts, hybrid securities, bonds designed at fair value, repurchase agreements and other complex illiquid instruments, for which the quoted market prices are not available. Therefore, the banks use special valuation techniques and models, sometimes established by the banks themselves, which are based on observable and unobservable inputs and assumptions. They present an area of judgement of the managers, since even the choice and parameters of the models are always the part of decisions that the managers make. Auditing these judgements and assumptions used is quite complex and the fact that appropriate valuation model or input might not been used presents a risk to financial statements. At the graph below the subcategories of financial instruments valuation topic can be observed, including the exact numbers of matters covering each of them. Valuation of intangible assets were related to the intangibles with indefinite useful life and valuation of IT assets and mentioned as a matter for the reports of two banks. The valuation and classification of loans were also present within this category, since loans are one of the most important type of assets for the banks, and the KAMs related to this were present in 7 reports out of 35 matters of the category. Very often the complexities of valuation and classification of loans were related to ECL model. As a result, this subcategory is strongly related to the impairment of loans and receivables category, where the ECL model was the major area of judgement and subjectivity of management.

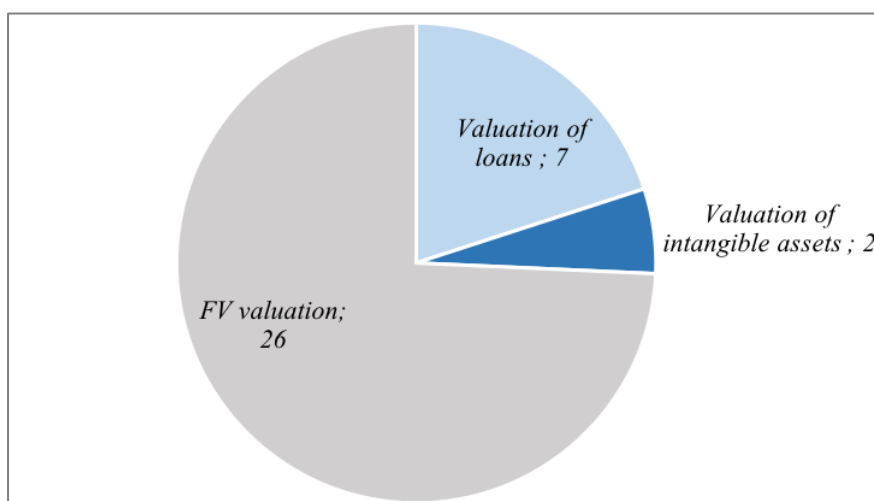


Figure 18. Subcategories of Financial instruments valuation category

If we take a look at the number of KAM, where ECL model required by IFRS 9 was at least mentioned once, we can see that this number is quite high – 39 matters in the reports of 39 banks, among which 35 belong to impairment of loans and receivables category and 4 to valuation of loans. Considering the loan volumes at the bank and the amount of uncertainty involved in the process of estimation of loan losses, it can be concluded that, as expected and described before in the theoretical overview, ECL model and IFRS 9 standard are of extremely

high importance to the banking industry in the EU and therefore for the auditors of the banking institutions too.

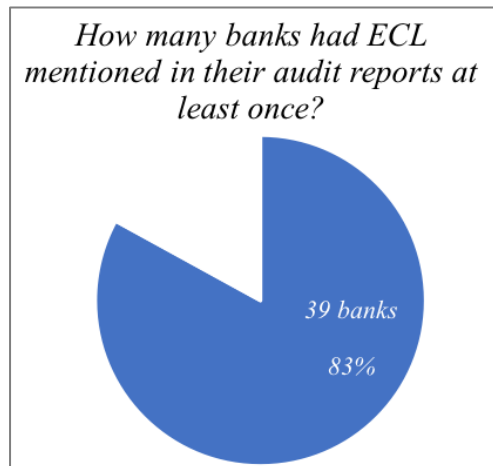


Figure 19. ECL model mentioning among banks in the EU

Concerning the audit response to valuation of financial instruments KAMs, among all the audit procedures, the auditors had to analyze the valuation techniques used by the banks as well as inputs and assumptions used in those techniques and verify whether these models are appropriate according to the market practice and whether the accounting is compliant with IFRS 9 and IFRS 13. The internal controls of the banks with regard to the measurement of financial instruments were reviewed. The recalculations and revaluations of the amounts on a sample basis were performed in many cases with the help of valuation experts too. The involvement of the experts in the audit process, such as valuation, IT and modelling specialists, related to this category of KAM is shown on the picture below. As we may see, 80 % of the matters in the category required the help from specialists during the audit procedures and in fact it is the highest level of involvement among the categories in analysis of KAMs.

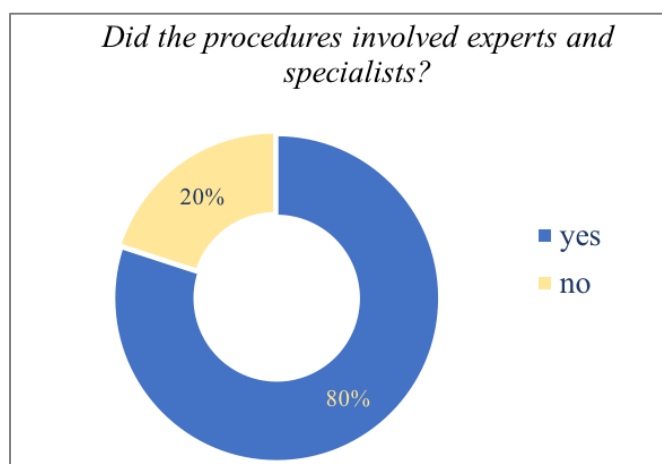


Figure 20. Involvement of experts into audit procedures of valuation of FI

'Information technologies systems' is one of the categories, which can be considered specific to the banking sector too, because of particular importance of integrity of IT systems there. The number of transactions processed is very high and IT systems should have proper user access management, maintenance of operations, improvements and changes in order to guarantee complete and accurate financial records. Audit of the IT system in big multinational banks is not an easy task due to the different locations and number of systems and applications in use. The tests of controls were performed in all of the cases, for instance the test of design and operating effectiveness of the internal IT controls related to the privileged access. On the figure 21 it can be seen more than in half of the matters the information technology specialists were involved in the audit procedures to support the auditors.

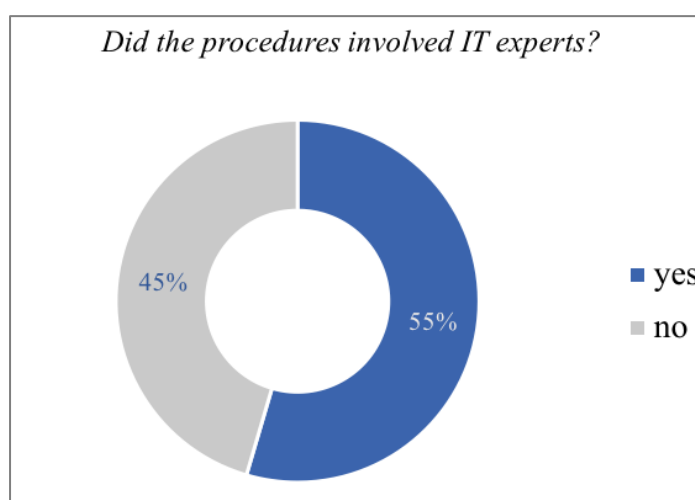


Figure 21. Involvement of experts into audit process related to IT systems

Legal, litigation and taxation matters were nearly as common as the IT systems, being present in the reports of 17 banks. These were related to provisions for lawsuits, taxes and regulatory proceedings. This is an area of high risk of material misstatement due to error or fraud. The compliance or litigation areas should be identified and addressed by managers on time, in particular in case there is a need for provision to be recognized or contingent liability to be disclosed. The outcome of the legal procedures is always unknown, but management has to exercise judgment to measure and recognize the provisions. The example could be the anti-money laundering investigations which may lead to the fines and sanctions imposed on a bank. Sometimes banks complete very sensitive operations, which can be vague in terms of law. In fact, effects from investigations of money laundering were communicated as a KAM in the reports of 3 banks, namely Swedbank, Danske bank and ABN AMRO. The banks sometimes need to make the judgements about tax liabilities that are subject to evaluation by tax authorities in different country may be potentially leading to legal processes, and there were 3 matters related to this. The majority of matters concerned legal risks, provisions and contingent

liabilities, however some matters contained all of the aspects, in other words there are matters such as ‘Provisions for taxes, lawsuits and regulatory proceedings’ in the report of Caixa bank or ‘Legal, tax and compliance risks’ in the report of Credit Agricole. The audit procedures performed in relation to the matters in this category were associated with the communications with the legal and tax departments of the banks and reviewing the documentation, analyzing the reasonableness of the expected outcome of the proceedings and other procedures. In majority of audit procedures in response to the matters, experts’ help was needed, especially legal, taxation, forensic specialists, precisely in 10 out of 19 matters, so their level of involvement is quite high in this category too.

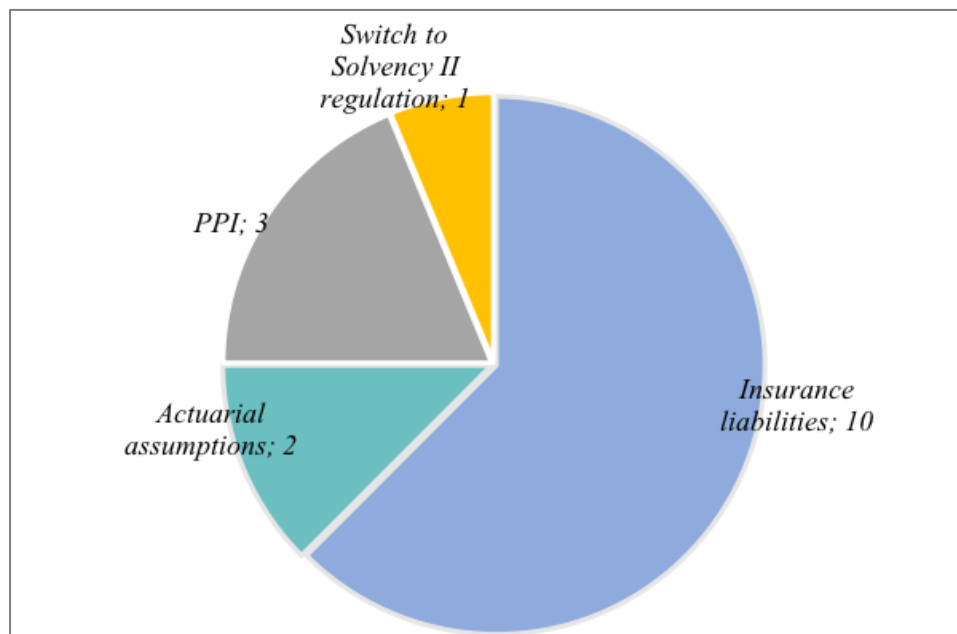


Figure 22. Subcategories of insurance topic of KAM

The insurance matters were present in the auditor’s report due to the existence of the insurance business line within the banks. Measurement of insurance liabilities require high level of judgment for the projections of future events, assumptions and calculations. The auditors examine the measurement of the insurance liabilities and make sure they are made in accordance with the regulations, analyze the liability adequacy test in relation to technical insurance provisions, make sure the actuarial assumptions are reasonable etc. Majority of the matters were focused on the measurement of insurance liabilities in form of technical reserves, as can be seen on the graph above. Apart from those, two matters were focused on the actuarial assumptions on the uncertain future outcomes in detail, since the auditor considered those in particular requiring a lot of audit attention. Another 3 matters were relating to the Payment protection insurance (PPI), since the calculation of provisions for conduct redness costs is not easy given the uncertainty about future complaints. It is worth mentioning that Belfius bank

from Belgium had 3 matters in this category, 2 concerning the technical provisions for life and non-life insurance respectively, and 1 concerning influence of Solvency II regulation on the capital position. The experts were involved in 11 out of 16 cases, which were mostly actuarial experts and legal experts. Therefore, this category of matters in general requires expertise of specialists, especially actuarial.

The next category is related to deferred tax assets (DTA). Measurement and estimations of recoverability of DTA are highly judgmental due to the need of assumptions and forecasts of future taxable profits based on the forecasted by managers financial statements and different parameters. Furthermore, these assets are present in many banks and tax planning strategies are complex due to the different tax laws and their interpretations in different countries. All these factors constitute additional complications for the auditors. The auditors had to obtain the understanding of the business plan and projections made by management, analyze the sensitivity of the assumptions, access the interpretation of the applicable laws and other procedures. In all cases except one the auditors involved taxation experts and less often valuation specialists.

We decided to highlight goodwill as a separate category, because the goodwill is a very particular type of asset and estimation of recoverable value of cash generating units (CGUs) to which it is assigned is very uncertain and bases on many assumptions. These assumptions relate to financial forecasts, discount rates, estimates etc. that management is required to make. The auditors have to evaluate criteria for CGUs, verify main assumptions such as growth and discount rates, compare the estimates and forecasts with the historical information and external available parameters. In majority of cases, namely seven out of nine matters, the expertise of valuation specialists was used during the audit.

Business combination matters were related to the acquisitions and valuation of associates and subsidiaries. The amounts are significant, and issue of valuation and recoverability of the investments in connected entity or purchase price allocations or first-time consolidation are uncertain and based on managerial judgment. The procedures applied by auditors varied based on the situation and 3 out of 9 matters required substantive audit procedures, while 4 involved valuation experts into the process.

Other matters category represented 10% of the remaining matters, namely 17 matters, and the main subcategories were pension, hedging, other impairments and restructuring as illustrated on the figure 23 below. The pension provisions are based on the actuarial assumptions and inputs like inflation rate, discount rate, mortality rate and are specifically present in the UK and Ireland due to complex pension legislation there. In all but one case

actuarial experts were involved into the audit process. Concerning restructuring provisions, all 3 of them were listed as a KAM in German banks related to the reduction of employees, severance and early retirement. The amounts were quite significant, and the measurement of these provisions is prone to managerial judgement, therefore auditors performed inspection of the restructuring plans, related assumptions and estimations, meetings and communications etc. Impairment of assets was related to the impairment of assets apart from loans and receivables, for instance real estate assets and internally generated intangibles. Hedging transactions and hedge accounting are complex in nature and auditors had to make sure the control environment works for the hedge items and whether the information complies with the IFRS requirements.

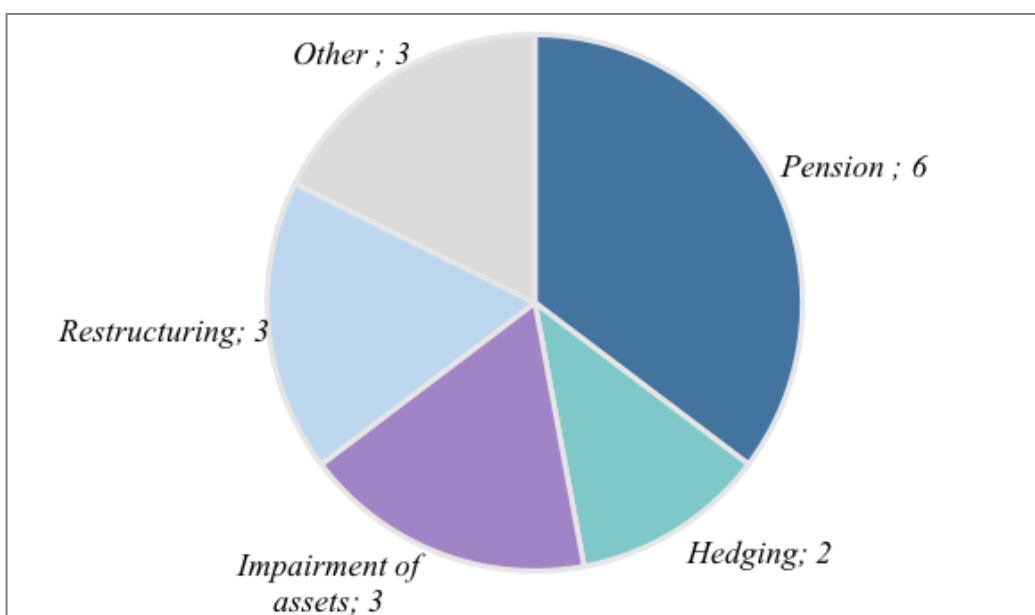


Figure 23. Other key audit matters subcategories

Before, the involvement of experts into audit procedures related to the main categories was shown, although it is also crucial to understand how often auditors required the assistance and expertise from the experts in general. The involvement of experts among all the key audit matters analyzed among banks from the EU is shown on the figure 24. This level is quite high, most of KAMs required inclusion of specialists due to the high complexity of audit procedures and the need of support in specific areas of expertise. Due to the great variety of the topics and matters reported, experts from very different areas had to be involved in the audit process, such as credit risk assessment specialists, IT, legal and taxation, forensic, modelling, actuarial, corporate finance, valuation experts and others.

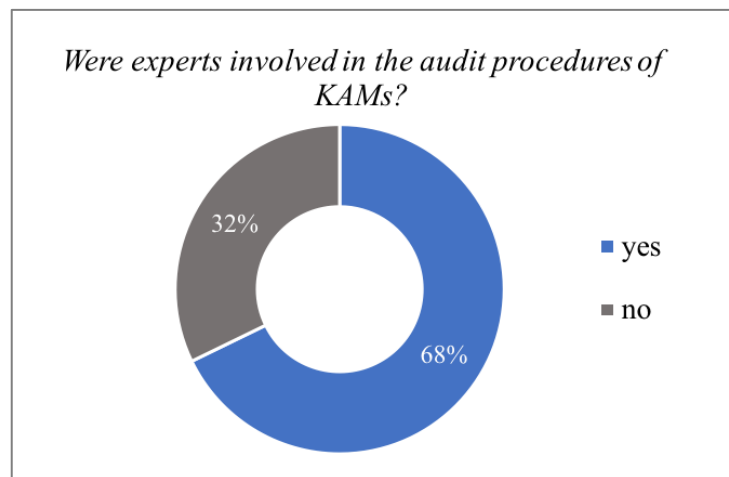


Figure 24. Involvement of experts into audit of KAMs

Analyzing the topics of KAM in the reports of the EU banks, the remark should be made that some particular matters were observed. These were the matters that combined different topics together and approaching their classification, the priority was given to the main topic, however they could relate to some other topics at the same time. For instance, in the report of Banco de Sabadell the auditor combined the impairment of loans and advances with the impairment of the real estate assets, even though normally they would be divided into different matters, especially if one of them concerns impairment of loans, regarding which many audit procedures had to be performed. However, this kind of situations were rare, so could not significantly impact the analysis of the main topics.

The key audit matters had a greater variety of topics than critical audit matters, and since there were less topics among the CAMs it was easier to divide them into groups. There were clearly prevailing CAMs categories in the reports of the American banks and other matters were encountered less often than among the reports of the banks from the EU. Observing the pie chart (figure 25), these principal categories of the topics can be seen, among which the top 3 topics are the following:

1. Allowance for loan losses, which accounted for vast majority of CAMs, namely 58%
2. Fair value of financial instruments, representing approximately 21% of all CAMs
3. Application of ASC 326 standard, representing roughly 9% of all CAMs

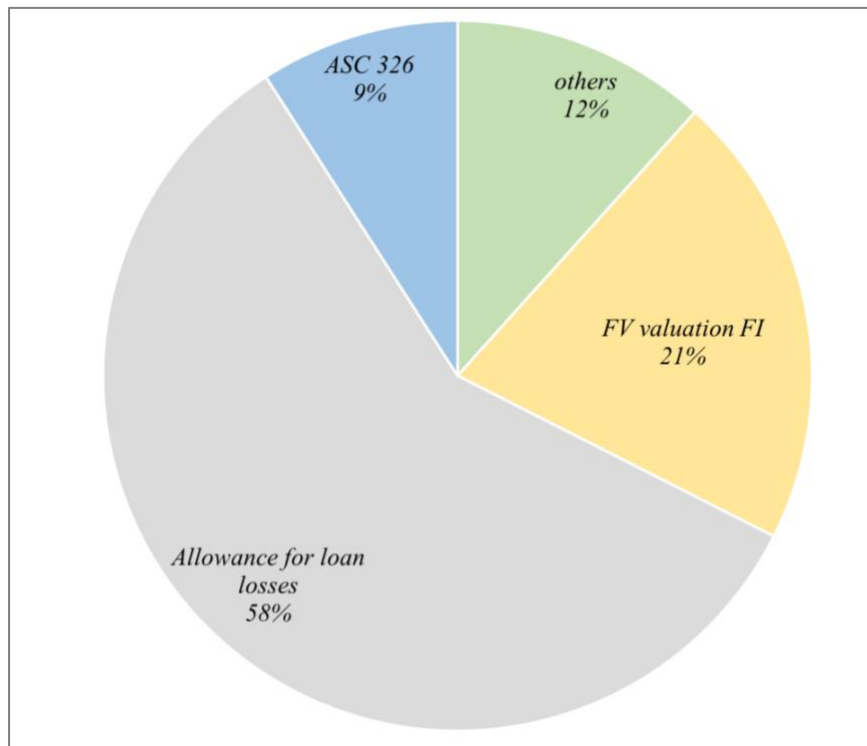


Figure 25. Most common topics of CAM in the reports of American banks

The principal category was not surprisingly related to the impairments of loans and receivables, in particular allowance for loan losses (ALL), which is a credit impairment related category of matters. This kind of matters were present nearly in every American bank, namely 45 out of 50 banks, which makes it 92% of the banks, while among the EU banks this proportion was 80%. Nevertheless, it is undeniable that impairment of loans and receivables is both key and critical matters category specifically pertaining to the banking industry, and the importance of correct application of standards related to loans impairment is indispensable for the banks and for the audit.

The banks utilize quantitative and qualitative components in the determination of credit losses, which both involve high degree of subjectivity, with the latter being called also ‘qualitative factor adjustments’ and in fact involving a higher level due to factors that represent managerial judgement such as concentrations of credit, legal and regulatory risks, changes in lending policies and procedures, economic conditions etc. Qualitative factors are those factors that cannot be quantified but have to be taken into consideration to adjust the valuation of credit losses, but in consequence the methodologies used by the banks to include this kind of factors require auditor’s attention. In fact, a big proportion of ALL matters highlighted precisely qualitative reserve component as the critical audit matter, which is depicted on the chart below.

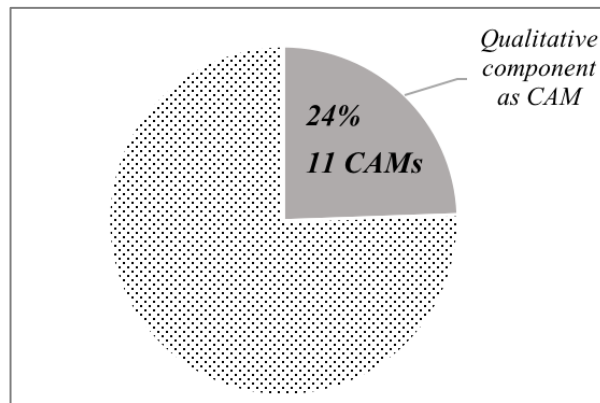


Figure 26. Proportion of qualitative component as CAMs among ALL category

Quantitative element of the valuation of losses represents econometric statistical loss forecasting models tailored to each portfolio based on default and severity information. Testing the effectiveness of controls relating to the estimation of loan losses in the banks were performed as well as testing the main assumptions and inputs and other audit procedures, performed with the help of credit risk professionals, which was used to evaluate the methodology of ALL and inherent assumptions as well as compliance with U.S. accounting principles quite often, as can be seen from the figure 27. This level is actually nearly equal to the one among key audit matters related to impairment of loans and receivables, where 71% required the assistance of experts.

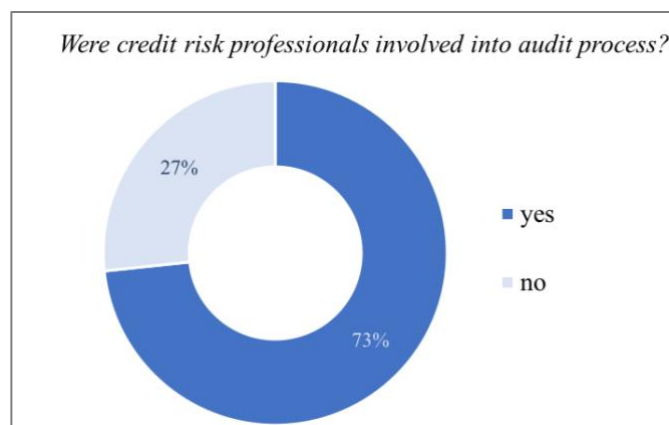


Figure 27. Involvement of experts into audit response within ALL category

The fair value of financial instruments was the second most frequently mentioned matter with 16 matters on its account communicated in the reports of 13 American banks. These matters were mostly related to the valuation of level 2 and 3 financial assets and liabilities, mortgage servicing rights were emphasized by 3 banks, and valuation of acquired assets, as shown on the following illustration. Due to the utilization of internal models and unobservable inputs, the valuation hard-to-price instruments required managerial judgement which in turn led to high level of subjectivity of the auditor and audit effort during the audit process.

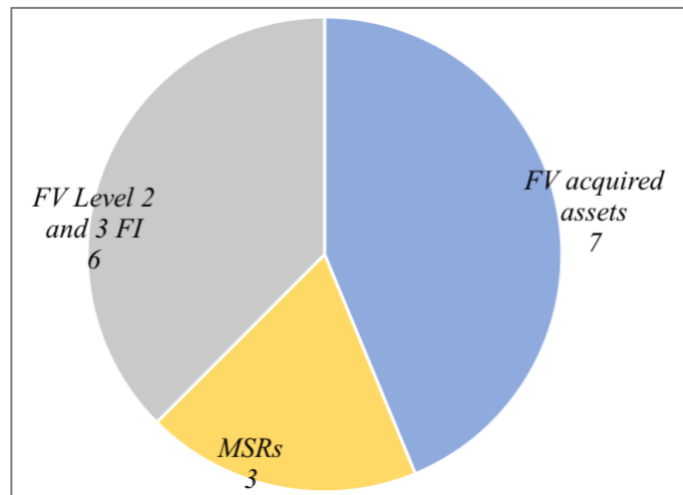


Figure 28. Subcategories of valuation of financial instruments category

The valuation of Residential Mortgage Servicing rights (MSRs) require performance of discounted cash flow (DCF), and estimations of its parameters such as prepayment rates and spread over the benchmark curve were subject to assessment of reasonableness by the auditors. The valuation of acquired assets, such as loans, leases and core deposit intangible assets were highlighted in 7 matters, which were connected with merger or acquisition happened before. The valuation of these assets is done using the DCF model too, and make assumptions like discount rates, loss rates, prepayment rates, servicing fees etc., all requiring auditor’s attention. The testing of internal controls was performed over the acquisition date fair value estimation process, together with the checks on the accuracy and completeness of data and calculations, and other procedures. The level of involvement of experts was very high, in fact in almost all matters professionals such as valuation experts and credit risk professionals were assisting in the evaluation of audit evidence related to these financial instruments, as visible in the chart below. It is even higher than the one among key audit matters focused on valuation of financial instruments, where the proportion was 80% of experts’ involvement in the audit process.

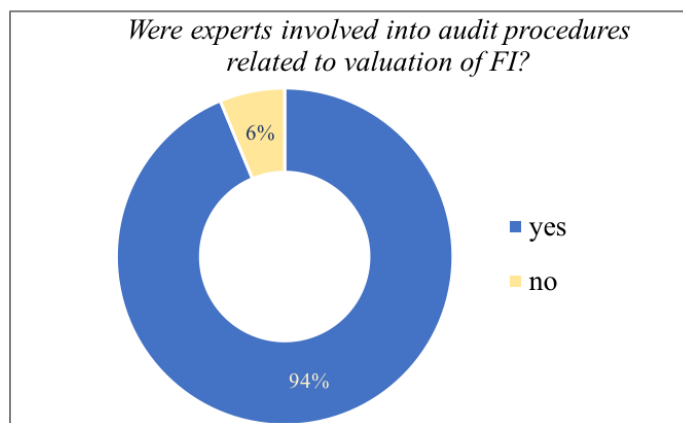


Figure 29. Involvement of professionals into procedures related to FV valuation of FI

The third category, which was encountered quite often in the auditor's reports is based on the transitions from one standard to a new one, specifically relating to the Accounting Standard Codification (ASC) 326 Financial Instruments – Credit Losses, in particular the Accounting Standards Update ASU-2016-13 Measurement of Credit Losses on Financial Instruments, which was planned to be adopted from January 1, 2020. We considered it important to highlight it as a separate category due to significant standard change and significant consequences for the financial statements of the American banks. According to the standard, the forward-looking Current Expected Credit Losses (CECL) model is introduced to calculate credit losses over expected life of loans of a bank rather than the incurred loss model under accounting principles generally accepted in the USA. This change from the incurred losses basis to the expected losses basis is going to impact the data collection processes of the banks, allowance estimation models and reporting in general. This category is quite close to the ALL category, since the adoption of the standard is expected to lead to significant increase in the allowances for credit losses. The evaluation of CECL transition effect required high extent of audit effort and subjective auditor judgement. Credit risk professionals were involved in the evaluation of reasonableness of assumptions, methodology, CECL transition effect and compliance with the standard in all of seven matters, so the involvement of the experts is the highest comparing to previous two categories, which is not surprising considering the drastic shift from the impairment valuation approach. To contrast with European experience, it is important to note that similar requirement of expected credit loss model is in place in Europe since earlier. IFRS 9 entered into force 1 January 2018, therefore the key audit matters dedicated to the transition effects were not widely present in the audit reports of 2019 financial statements of banks since it was not even the first year of standard application. However, in the previous years this topic was commonly present among the European banks, as was reported by the Accountancy Europe research, where 24% of audit reports of 64 European banks had a key audit matter related to impact of transition to IFRS 9 standard.

In comparison with the banks from the EU the IT system matters were not present, but this was expected due to the already described differences in definitions between KAM and CAM, since CAM has to relate to account or disclosure to financial statements. The other matters mentioned in the auditor's reports of American banks are depicted on the figure 30 as well as the numbers of matters corresponding to each of them, and were related to the following topics:

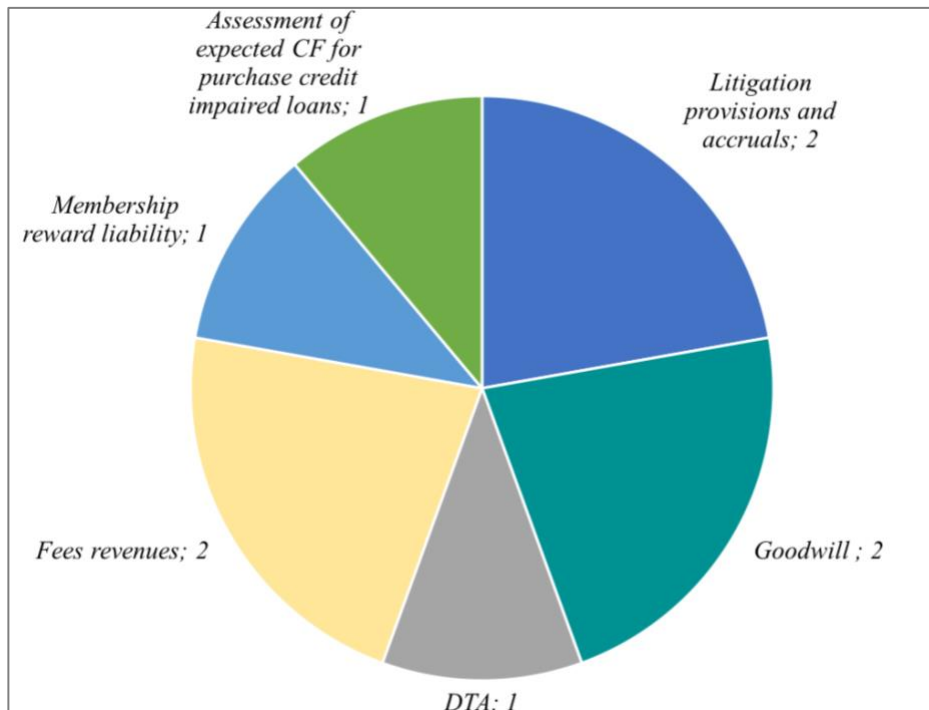


Figure 30. Other CAMs

- Litigation and legal provisions, 2 banks.

The provisions for losses from litigations and regulatory proceedings were not a very frequent topic in the reports of the American banks compared to the reports of the EU banks, where it was one of the top matters. It was present in the reports of Bank of New York Mellon and Goldman Sachs.

- Goodwill, 2 banks.

Goodwill was considered as a CAM in Valley and Capital One banks in a large part due to significant assumptions like prospective financial information and was addressed by performing test of controls with the help of valuation experts.

- Fees revenues, 2 banks Charles Schwab

Non-standard nature and big volume of contracts in State Street Corporation and revenues from asset management and administrative fees (AMAF) that required involvement of IT specialists in Charles Schwab bank represent this subcategory.

The remaining matters were related to membership reward liability, deferred tax assets and assessment of the remaining expected cash flows for purchase credit impaired loans. The membership reward liability of American Express bank and represents management's estimate of Membership Rewards points that will be redeemed, therefore is prone to judgment and required tests of controls regarding the Ultimate Redemption Rate (URR) assumption. The

DTA topic was less common than in the EU, in the USA only Citibank had this matter in the report, which concerned DTA for foreign tax credits and required the knowledge of global tax regulations.

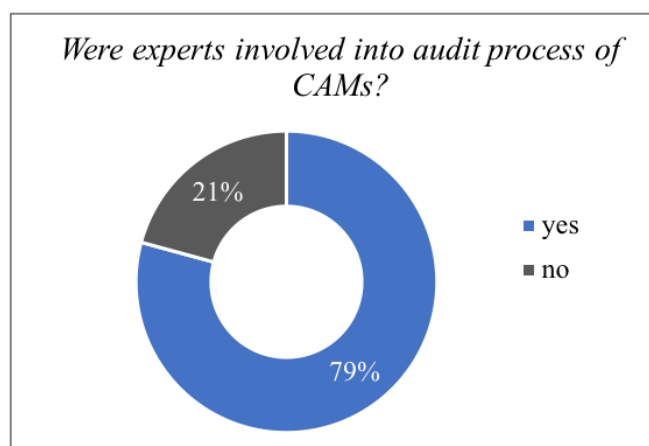


Figure 31. Involvement of experts and professionals into audits of CAMs

The level of general involvement of experts and professionals into the audit process, such as credit risk, valuation, IT and tax experts, among all critical audit matters is shown on picture 31. Compared to the key audit matters this is a higher level of involvement, since there the proportion was 68 % of matters with experts help. The factor that could influence that is the higher proportion of matters requiring the highest level of involvement of experts, namely, allowance for loan losses and financial instruments valuation, to which 79% of the CAMs belonged in comparison to 41% of the KAMs. However, among KAMs auditors invited experts from many different areas of expertise, due to the presence of more diverse topics and issues than among CAMs.

2.4. Presentation format of the KAMs and CAMs

The format of presentation is very important, since it is a matter of clarity for the reader and the quality of the auditor's communication of matters. The auditors normally operate with technical language and their goal is to present the insights from their audit process in an understandable and easy to comprehend way, otherwise the key and critical audit matters lose the value to the stakeholders. The readers of auditor's reports consider graphic and concise presentation the most valuable as found by Köhler et al., so the paragraphs should not be extremely long. The importance of matters to be entity-specific rather than standardized is highlighted by the authorities, therefore the auditor's task is to be precise, not generic and describe a matter accordingly to an entity's situation. The key and critical audit matters should not become just a mechanical exercise or another bureaucratic requirement for the auditors, but

a useful tool for the auditors to communicate the significant issues in the audit for the stakeholders and make it an informative section for them.

The easiest to read and comprehend KAMs sections in the European banks' reports were in table format, where the first column was the matter description and the second the audit procedures performed to address the matter, containing bullet points and headings. The good example could be of the Nordea bank prepared by PWC, depicted below. It is quite concise and contains a lot of relevant information without too much special terminology.

Key audit matter in the audit of the group	How our audit addressed the key audit matter
<p>Impairment of loans to customer</p> <p><i>Refer to the Note G1 - Accounting policies (Critical judgements and estimation uncertainty), Note G11 - Net loan losses and Note G14 - Loans and impairment to the consolidated financial statements.</i></p> <p>A high level of judgement is involved in determining the appropriate impairment loss to be recognised. For individually assessed loans, judgement is involved in determining whether a loan has a loss event and in assessing the loan loss amount.</p> <p>Expected credit losses (ECL) are calculated as a function of the probability of default, the exposure at default and the loss given default, as well as the timing of the loss.</p> <p>Nordea categorises loans into three stages depending on the level of credit risk or changes in credit risk for each individual loan. For loans without significant increase in credit risk, stage 1, expected credit losses are calculated for estimated defaults within 12 months. For loans where there is a significant increase in credit risk, stage 2, or loans in default, stage 3, a lifetime of expected losses are calculated.</p> <p>Nordea uses adjustments to the model-driven ECL results to address impairment model limitations and market trends.</p> <p>This is also a key audit matter with respect to our audit of the parent company financial statements.</p>	<p>Our audit included a combination of testing of internal controls over financial reporting and substantive testing.</p> <p>We obtained an understanding of the loan origination process, credit risk management and the impairment allowances for loans and advances to customers.</p> <p>We had a special focus on ECL model updates and the credit risk development for large customers.</p> <p>Based on risk, we selected individual loans and performed detailed credit file reviews and assessed its credit risk.</p> <p>For ECL models, we involved our modelling specialists to assess the methodology, challenge the underlying assumptions and to independently reperform the calculation for a sample of loans.</p> <p>We evaluated adjustments to the model driven ECL and reviewed that governance procedures have been performed.</p> <p>We assessed the disclosures related to impairment of loans.</p>

Figure 32. Example of table format presentation of KAMs

In contrast, the text format sections usually take much more space and make the report longer and do not visualize the matters in the best way, the example could be a KAM paragraph of DZ Bank from Germany, part of which is depicted on the figure 33. Each matter took more than one page, there are no bullet points, just the plan test containing description of a matter and auditor's response and as can be seen on the picture, where only the beginning of the audit response to a matter is shown, it is definitely inferior to the previous example in terms of readability and presentation in general.

Some of the audit reports contained also observation or results section, where auditors expressed comments or general impression of the matter. One of the examples of this kind of disclosure could be from the report of Barclays bank prepared by KPMG illustrated on the picture 34. Even though it is not the most concise, it is very readable due to the presence of the headings, summarizing the following information. It was one of the reports having the best presentation formats of all and could be definitely considered example of best practice, since it

is tailored to the bank and does not contain a large amount of specific language. This kind of format definitely brings more value to the readers and fulfills the goal of effective communication of the matters by the auditor.

<p>Auditor's response</p> <p>During our audit we obtained an understanding of the process for processing claims and determining the gross provisions for reported, and incurred but not reported claims and the procedures, methods and controls used therein. We examined the gross provision for reported claims from direct non-life business by reference to the processing of individual claims to determine whether the process for processing and provisioning claims – from the reporting of claims to the accounting for claims in the consolidated financial statements – is appropriately designed so as to ensure complete and correct recognition. We tested the design and operating effectiveness of significant controls in this regard.</p> <p>In addition, for a deliberately selected sample of direct non-life claims, we examined whether the provisions recognised for known claims are sufficient on the basis of the information and insights available as at the reporting date. Furthermore, with the aid of data analytics, we analysed the quality of data underlying this claims reserve by examining the sum and age structure of the individual claims. We also analysed the claims ratios and claims averages by referring to multiple-year comparisons in order to identify any anomalies in the measurement. In addition, we examined the data used in the calculation in the form of the claims register for completeness and analysed and examined the adequacy of the calculations for the underlying expected extrapolated future claims figures. In addition, we examined the procedure for determining estimates of expected indemnification amounts to identify whether judgement was used within a reasonable range to determine indemnification amounts.</p>
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Figure 33. Example of text format of KAMs communication

<i>Key audit matter</i>	<i>How our audit addressed the key audit matter</i>
<p>Provisions for legal, competition and regulatory related matters</p> <p>31 December 2019 €376m, 31 December 2018 €414m</p> <p>Refer to pages 300 and 302 (accounting policies on provisions and on contingent liabilities and commitments), page 300 (financial disclosure note 24 Provisions) and page 303 (financial disclosure note 26 Legal, competition and regulatory matters)</p> <p>Exposure completeness The Group and Parent company operate in a highly litigious and regulated environment and faces legal, competition and regulatory challenges which can lead to potential claims and exposures (together 'legal, competition and regulatory matters'). In certain legal, competition and regulatory matters significant judgement is required by the Directors to determine if there is a present obligation under relevant accounting standards.</p> <p>Subjective estimate If there is a present obligation the amounts involved can be potentially significant, and the application of accounting standards to estimate the expected outflow, if any, of any provision to be recognised is inherently subjective.</p> <p>The effect of these matters is that, as part of our risk assessment, we determined that the provisions for legal, competition and regulatory matters have a high degree of estimation uncertainty, with a potential range of reasonable outcomes greater than our materiality for the financial statements as a whole.</p> <p>Contingent liabilities When a provision is not recognised for possible significant outflows, but there is more than a remote likelihood of an adverse outcome, the disclosure requirements under IAS 37 is key to understanding the risks and potential effect on the Group and Parent company.</p>	<p>Our procedures included:</p> <p>Inspection of Board of Directors meeting minutes: We inspected the Board of Directors meeting minutes to obtain an understanding of the status of all significant legal, competition and regulatory matters.</p> <p>Assessment of regulatory correspondence: We inspected correspondence with the relevant regulatory authorities to identify actual or possible non-compliance with laws and regulations that may have a material effect on the financial statements and for the most significant matters, enquired directly with the relevant regulator.</p> <p>Enquiry of lawyers: For significant legal, competition and regulatory matters we enquired of the Group and Parent company's internal legal counsel and inspected internal notes and reports. For the most significant legal, competition and regulatory matters we also received formal confirmations from external counsel and had discussions with external counsel. Based on these procedures we challenged the timing of the recognition of provisions where there is potential exposure but it is not clear whether a present obligation exists.</p> <p>Test of details: For the significant legal, competition and regulatory matters, we independently assessed the estimated value of the provisions, based on our enquiries of lawyers and information obtained from our other procedures.</p> <p>Assessing transparency: We assessed whether the disclosures detailing significant legal, competition and regulatory matters adequately disclose the contingent liabilities and the significant uncertainties that exist.</p> <p>Our results: The results of our testing were satisfactory and we considered the provisions recognised, and the contingent liabilities disclosures made, to be acceptable (2018 result: acceptable).</p>

Figure 34. Example of presentation of KAM in the Barclay's report

The styles of the communication of the matters differed between reports from the EU and the USA. The styles and formats of presentation in the reports of European banks varied much more than among reports from American ones, however needless to say that the reports from the same audit firms usually had similar presentation format and style of communication of matters, for instance in majority of reports PWC followed table format. But all of the CAM sections were prepared in the text format, but due to the smaller number of matters and more

concise information they were fairly easy to read. The cross referencing to the financial statements were present in all of the reports. The American reports contained less formal and specific wording and many clarifications of crucial and complex concepts. This could be beneficial from the point of view of investors and other stakeholders, since it is much easier and time wasting to comprehend such a report. The justifications of inclusion to CAMs were usually concise and included main reason only, compared to the KAMs descriptions. It is important to remember the intended goals of the concept, which is to highlight significant matters for users and improve the level of transparency in general. For instance, the UniCredit auditor's report was 11 pages and the description of every matter was very detailed compared to any of the reports of American banks, which were shorter, around 2-3 pages, and were more similar to a summary prepared for the readers of the reports, even of the largest banks such as Bank of America, JP Morgan Chase and Citi. As was already mentioned, the CAMs topics were easier to divide into categories, since their variety was smaller than that of KAMs.

However, this could be a potential sign of higher level of standardization of the reports prepared. In fact, reading some of the reports of different banks, especially prepared by the same audit firm on similar topic, gave the impression that the CAMs were described using a standardized template. For instance, reports made by PWC on the allowance for loan losses descriptions contained the same phrases such as 'The principal considerations for our determination that performing procedures relating to ...'; 'Addressing the matter involved performing procedures and evaluating audit evidence in connection with forming our overall opinion on the consolidated financial statements. These procedures included testing the effectiveness of controls relating to the...'; 'These procedures also included, among others, testing management's process for...'. Similar 'patterned' sentences were found in the reports prepared of KPMG too. Of course, this kind of introducing sentences were tailored to each matters and the exact measures were described depending on the situation in each bank, however one may ask the goal of such a long phrases in the report containing absolutely standardized language with no specific information particularly valuable to the users of the report. Especially considering that the CAMs section is quite concise in the reports of the American banks. However, this can be attributable to the fact that this was the first year of implementation of the critical audit matters in the auditor's reports and that the auditors in the following years will improve the communication of CAMs after the extensive feedback from the stakeholders and authorities.

The references to notes of the financial statements were present in all of the reports, where applicable, most often emphasized. Since some matters due to their nature did not relate

directly to financial statements, such as IT systems, references were not applicable even though the matters presented significant audit risk and considered a key audit matter. Concerning special paragraphs, emphasis of matter paragraph was found in five reports of the European banks only. Interestingly, three of them, namely French banks Credit Agricole, Société Générale, BNP Paribas, drew attention to the changes in the standard IFRS 16 – Leases and effect of first-time application on the financial statements. This is actually expected, since the standard is effective January 1, 2019 and presents significant changes for any corporation that leases big assets, for instance real estate. The emphasis of KBC bank had the coronavirus pandemic as an emphasis of matter with a remark that it had no impact on the audited financial year but is going to have downward pressure on the results in 2020. In fact, the coronavirus remarks were expected to be noticed more often, however, the financial reporting of 2019 did not suffer from the pandemic consequences yet, however it is definitely expected to be seen as among the emphasis of matters as among key audit matters descriptions. The last emphasis of matter paragraph belonged to the report of Banca Montepaschi di Siena, attracting attention to the restructuring plan and forecasted financial statements prepared by the management and included in the report of operations. Among the American banks, there were no emphasis of matter paragraphs, and in fact it was mentioned by other studies that special paragraphs are used less frequently in the USA compared to Europe.

Conclusions

The key and critical audit matters paragraphs are the useful tools for auditors to communicate the main issues during audit process of the financial statements and in this thesis the ways they are being implemented were observed, with particular focus on the reports of the banks. In chapter 1 the analysis of the key and critical audit matters as concepts in the literature was performed, following with the research of KAMs and CAMs paragraphs in the reports of the banks in the EU and USA in chapter 2, which allowed us to find out the main trends and characteristics of the matters in the banking industry as well as to make a comparison between the EU and the USA.

The introduction of key and critical audit matters was made in response to the need of more informative, relevant auditor's report. The KAMs are the most significant matters during the audit process of the financial statements communicated by the auditors, which do not change the audit opinion nor provide separate opinion on the lines of the financial statements. This is an additional informational paragraph, explaining the main issues in the audit of an entity. The requirement to report them is applicable for the listed entities by IAASB and the public interest entities in the EU. This section of the auditor's reports brings the benefits to the corporate governance in terms of improving the communication between the auditors, management and audit committees, to the financial reporting quality through the disciplining effect on management, to the auditors and audit profession as well as to the reduction of the audit expectations gap by increasing awareness about auditor's job and informational gap by providing additional insights for the decision-making of the users of the reports. The critical audit matters are similar to KAMs, but not identical, since these matters involve especially challenging, subjective, or complex auditor judgment, but have to be related to account or disclosure material to financial statement. That is why a certain matter for the same company may be considered a key, but not a critical audit matter.

From the review of the previous studies on the key audit matters several important observations were found. The key audit matters from the EU countries showed general similarities in those characteristics with averagely 3 matters reported, with the exception of the UK and Ireland, where the regulations differ. With the increase in market capitalization, as well as in a number of business segments in the company, the number of key audit matters rises and some industries show higher average numbers of matters reported, namely banking, insurance, telecommunication due to the high complexities of the operations there. The other factors like different approaches of different audit firms, auditor's characteristics and relationship between the auditor and management, were found to influence KAMs reporting too, since the auditors

apply a certain level of judgement in the determination of the list of the matters. Due to the much recent introduction of the CAMs, only the first data from large accelerated filers is available, and according to it, the average numbers in the reports was lower than in Europe, less than 2 matters on average, and the paragraphs were less extensive. The main topics among all entities were quite similar, e.g. the impairment of assets, especially goodwill and intangibles, revenue recognition, fair value valuations, taxation and legal matters, business combination, which were among the most frequent topics also in the reports of European entities. However, the main topics differed depending on the industry, and our analysis focused then on the banks as the institutions, having extreme importance to the economies and performing particular types of operations.

By looking closely at the banks, it was previously found that in Europe they had higher mean number of matters reported than among all industries and the principal topics differed significantly, with impairment of loans and receivables, financial instruments and IT matters being the top 3 ones. Moreover, these topics recur within time and therefore could be considered specific to the banks. The stakeholders of the banking institutions were found to meet positively the key audit matters communication and increase transparency and stability in the industry.

Even though criticism exists around these concepts, such as low readability, high standardization, auditor liability related issues and others, in general the key and critical audit matters fulfil the expectations from the authorities and public. KAMs and CAMs have an advantage in comparison to footnotes or other parts of the financial statement – it is prepared by an independent party and therefore has higher credibility. The COVID-19 pandemic is expected to influence these paragraphs, such as increase the levels of uncertainty in the areas of significant judgment that auditors have to deal with in order to provide a reasonable assurance and increase the complexity of audit process. The number of the matters reported and other paragraphs, such as emphasis of matter, is expected to rise too, especially related to the going concern. The further research should be done in order to examine the consequences on the following years auditor's reports.

In order to discover important characteristics of the KAMs and CAMs among banks and compare the situation in the EU and USA in detail, the analysis of implementation of KAMs and CAMs was performed on the sample of 47 largest banks by asset size in the EU and 50 largest accelerated filers banks by assets in the USA. Beginning with the first characteristic, the average number of matters reported, it was found that mean number of KAMs is higher than CAMs, 1,54 and 3,766 respectively, which is attributable, at least to a certain extent, to the narrower definition of the critical audit matters. Within the EU counties, the numbers did not

vary significantly with the exception of the UK and Ireland, where the mean number of matters reported was notably higher due to differences in the legislations, such as pension schemes, and separation of similar topics into several matters instead of combining them. Concerning the idea that different audit firms may interpret and apply the key audit matters in their own way, it could not be confirmed, since there was no significant difference between the number of matters reported by each of the big four audit firms found, neither in the EU case, nor in the American one.

In terms of the most important topics of the matters for the banks, impairments of loans and receivables and financial instruments valuation, were the two major ones in the EU and the USA. In relation to the former, the forward-looking expected credit loss model (ECL), which allows to calculate how much money is going to be received from the borrowers, is the key concept in the reports of the EU banks, considering the uncertainty and the amounts of loans involved. Among American banks, the transition to the new ASC 326 standard from January 1, 2020, introducing similar expected credit loss model, rather than previously used incurred loss model, is of a great importance too and is expected to lead to significant rise in allowances for loan losses. Since it directly influences the banks' profitability the auditor's attention to this model is very close in the banking industry. The second category, the valuation of financial instruments, especially fair value levels 2 and 3, due to the usage of complex internal models of valuation and unobservable inputs required exceptionally high level of involvement of experts, that is 80% of KAMs and 94% of CAMs. Among the EU banks, apart from the two main topics, the IT related issues were significant, being the third most frequent topic, while not present at all among critical audit matters, due to the immateriality to the financial statements. In general, the variety of topics of KAMs was greater than among CAMs. As a matter of fact, apart from the mentioned three main categories in the EU, legal and litigation, insurance, deferred tax assets, goodwill, business combination and other matters made up nearly a half of all key audit matters. At the same time, in the USA the allowance for loan losses, financial instruments valuation and transition to the ECL model composed a vast majority, 88% of all matters. Comparing the general involvement of experts between the EU and USA banks, it was found out that it was higher for the American banks, that could be in part explained by the higher proportion of allowance for loan losses and financial instruments, which required the highest levels of involvement of experts.

The presentation of the matters was another crucial characteristic that was observed in order to understand if the matters were communicated in a comprehensible and clear way for the users of the reports, with the emphasis on the length, language, formatting and how tailored

the paragraphs are to each entity. In the reports of European banks, the presentation formats such as tables with ‘description’ and ‘addressing the matter’ columns, sometimes also ‘auditor’s observation’, as well as bullet points and headings were considered having the highest readability, while the text formats and especially those full of specialized terminology, most probably not known to the average investor not related to the audit profession were not considered preferable. Some of the paragraphs, belonging to some of the European banks, were very long and difficult to understand due to the usage of technical language. This practice is not advisable since in this way the valuable information for the stakeholders loses its effectiveness. The CAMs paragraphs were normally shorter than the KAMs and contained less formal language and more clarifications about complex concepts. This concise communication of matters is definitely a benefit for the readers, especially investors, but at the same time the signs of a template usage were found in some of the American reports, especially in those prepared by the same audit firm on similar topic. This sort of standardization should be avoided, and each matter should be tailored to an entity’s particular situation. Hopefully, with the feedback from the readers the quality will rise, since it was only the first time of CAMs reporting in the USA. The suggestion regarding presentation would be the establishment of the best practice, in other words the authorities should share the examples of presentation formats advised and possibly bad examples too, with the feedback from stakeholders. These publications could serve as guidelines for the preparation of key and critical audit matters section for the auditors to keep it effective and valuable for the users of the reports.

On the whole, this research provided the first comparison between the key and critical audit matters among banks, together with the detailed description of their main characteristics and trends in the banking industry. A recommendation for the further research would be to analyze the critical audit matters among all filers, since the critical audit matters requirement was introduced last year only for large accelerated filers. Furthermore, the comparison between the key and critical audit matters within some period of time, at least 2 or 3 years should be done. It would allow to observe the recurring issues and discuss long-term added value of these concepts. After all, the outputs from this kind of studies may bring additional insights for the authorities and auditors on developing the audit standards and improving the quality of auditor’s report.

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Appendices

Appendix A. The list of largest banks by asset size in the EU

#	Country	Bank	Asset size (billion euros)
1	UK	HSBC	2419,47
2	France	BNP Paribas	2164,71
3	France	Crédit Agricole	2010,97
4	Spain	Banco Santander	1517,27
5	France	Société Générale	1356,3
6	UK	Barclays	1345,68
7	France	BPCE	1338,06
8	Germany	Deutsche bank	1297,67
9	UK	Lloyds Banking Group	984,15
10	Italy	Intesa Sanpaolo	942,63
11	Netherlands	ING	891,74
12	Switzerland	UBS Group	866,31
13	Italy	Unicredit	855,65
14	UK	Royal bank of scotland	853,32
15	France	Crédit Mutuel Group	852,56
16	Switzerland	Credit Suisse Group	724,38
17	Spain	Banco Bilbao	696,93
18	UK	Standard Chartered	641,95
19	Netherlands	Rabobank	590,6
20	Germany	DZ bank	559
21	Sweden	Nordea bank	554,85
22	Denmark	Danske Bank	503,32
23	Germany	Commerzbank	426,3
24	Spain	CaixaBank SA	391,41
25	Netherlands	ABN AMRO	375,05
26	Sweden	Svenska Handelsbanken	292,81

27	Belgium	KBC Group	293,17
28	UK	Nationwide Building Society	281,96
29	Sweden	Skandinaviska Enskilda Banken	272,49
30	France	La Banque Postale	271,68
31	Germany	Landesbank Baden-Württemberg	256,63
32	Austria	Erste group	245,69
33	Sweden	Swedbank	229,72
34	Switzerland	Raiffessen Gruppe Switzerland	228,5
35	Germany	Bayerische Landesbank	226
36	Spain	Banco de sabadell	223,75
37	Denmark	Nykredit	215,5
38	Spain	BFA Sociedad Tenedora de Acciones	210,78
39	Germany	Landesbank Hessen-Thüringen Girozentrale	207,03
40	belgium	Belfius Banque	172,44
41	Italy	Banco BPM	167,04
42	switzerland	Zürcher Kantonalbank	153,71
43	Austria	Raiffeisen Bank International AG	152,2
44	Finland	OP Financial Group	147,02
45	Germany	Norddeutsche Landesbank Girozentrale	139,62
46	Italy	Banca Monte dei Paschi di Siena	132,2
47	Ireland	Bank of Ireland Group PLC	131,88

Appendix B. Top 50 large accelerated filers banks by asset size in the USA

#	Bank	Asset size
1	JPMorgan Chase Bank	\$2,690,959,000
2	Bank of America	\$2,031,940,000
3	Wells Fargo Bank	\$1,763,696,000
4	Citibank	\$1,632,405,000
5	U.S. Bank National Association	\$533,129,091
6	Truist Bank	\$495,079,000
7	PNC Bank	\$433,803,038
8	The Bank of New York Mellon	\$387,037,000
9	State Street Bank and Trust Company	\$359,196,000
10	Capital One	\$339,215,513
11	Charles Schwab Bank, SSB	\$270,245,000
12	Goldman Sachs Bank USA	\$254,668,000
13	Fifth Third Bank	\$183,723,698
14	Morgan Stanley Bank	\$178,664,000
15	Citizens Bank	\$176,632,580
16	Ally Bank	\$170,655,000
17	The Northern Trust Company	\$161,163,529
18	KeyBank National Association	\$154,993,507
19	Regions Bank	\$132,707,000
20	American Express National Bank	\$130,004,248
21	Manufacturers and Traders Trust Company	\$124,147,394
22	First Republic Bank	\$123,914,929
23	The Huntington National Bank	\$113,764,077
24	Discover Bank	\$111,140,060
25	Synchrony Bank	\$85,811,000
26	Comerica Bank	\$76,262,000
27	Silicon Valley Bank	\$73,632,403
28	Zions Bancorporation, N.A.	\$71,466,849
29	People's United Bank	\$60,206,875
30	New York Community Bank	\$54,237,201

31	Signature Bank	\$53,074,716
32	CIT Bank	\$52,993,207
33	Synovus Bank	\$50,521,947
34	E*TRADE Bank	\$50,294,236
35	TCF National Bank	\$48,562,805
36	First Horizon Bank	\$47,026,241
37	BOKF	\$46,955,256
38	East West Bank	\$45,939,280
39	Banco Popular de Puerto Rico	\$42,267,000
40	First-Citizens Bank & Trust Company	\$41,376,966
41	Valley National Bank	\$39,109,234
42	Texas Capital Bank	\$35,847,732
43	First National Bank of Pennsylvania	\$35,014,804
44	Frost Bank	\$34,248,863
45	Associated Bank	\$33,859,027
46	Raymond James Bank	\$33,656,415
47	BankUnited	\$33,512,179
48	Iberiabank	\$32,147,468
49	Sallie Mae Bank	\$31,775,269
50	Hancock Whitney Bank	\$31,745,664