

CHAPTER 1

INTRODUCTION

1.1. Background Problem

Financial reports play an important role in supporting country's development by providing decision makers with essential information. Due to the importance of financial reports, high-quality audit becomes important to safeguarding the public interest (Anjani, 2023). The quality of an audit has always been a critical concern especially in corporate reporting, because it has direct impact on the reliability and credibility of the corporate's annual reports, including financial and also non financial information. Audit quality can be thought as the confidence the market places in an auditor's ability to not just uncover risks in a client's financial records, but to also speak up and report them truthfully (Yousefi Nejad et al., 2024a). This definition explaining two critical aspects, where the auditor's competence in detecting significant errors or misstatements, and their independence in reporting those findings. This highlights that the quality of an audit rests not only on the auditor's ability to uncover issues in a company's reporting, but also to communicate them objectively. Therefore, this will ensures that both the financial figures and the broader context is reliable and trustworthy. In a growing economic uncertainty and increasing complex of business environments, stakeholders are increasingly emphasizing the importance of the auditor's competency in delivering audit reports that demonstrate professional judgment, clear communication, and comprehensive understanding of significant audit

matters. In this context, auditor's report not just as a bridge that connecting companies with their stakeholders but also reinforcing confidence in the information disclosed.

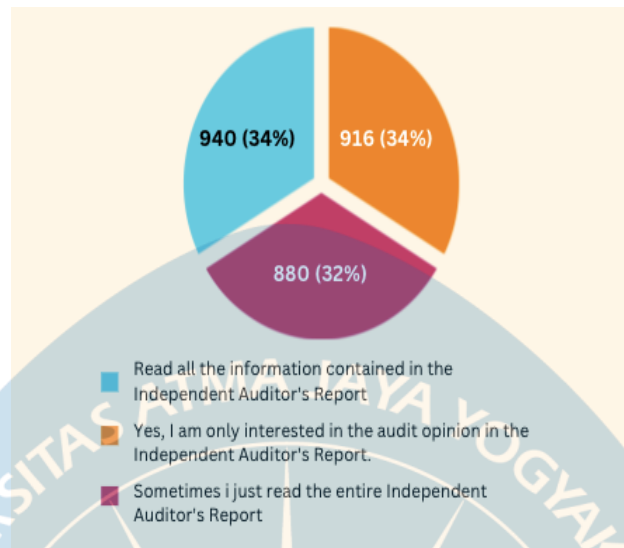
According to Murti & Firmansyah (2017) Auditors are required to consistently prioritize the quality of their audit to foster public confidence and support stakeholders in making informed decisions based on reliable and accurate financial informations. In practice, auditors have often fallen short of fully meeting the expectations of high quality of an audit. The declining competence and independence of auditors, the increasing frequency of corporate accounting manipulations have led to a loss of trust among users of audited financial statements, raising doubts about whether public accountants truly act as independent and credible entities. A notable example is the Enron case, where the company's directors, driven by the desire to secure incentives such as bonuses, manipulated financial statements, ultimately leading to the company's bankruptcy (Junaidi & al, 2016). This fraudulent activity also involved Arthur Andersen, once one of the Big Five public accounting firms, which whether deliberately or not, attempted to conceal Enron's financial issues. As a result, significant financial losses were incurred by investors both in the U.S. and globally.

PT Garuda Indonesia's financial report The 2018 Garuda Company investigation was one of the largest audit cases in Indonesia (Maryanti et al., 2024). The financial report that was audited by AP Kasner Sirumapea of KAP Tanubrata, Sutanto, Fahmi, Bambang and Partners demonstrating significant problems in auditor diligence. Garuda was found to have manipulated its financial statements by improperly recognizing revenue from a contract that was not yet finalized. This manipulation inflated Garuda's profit by approximately USD 211 million for the fiscal

year of 2018, resulting an inaccurate picture of the company's financial health. The auditors failed to identify and report this misstatement and overlooked fundamental auditing principles such as revenue recognition and the need for careful scrutiny of contractual terms. Their failure to apply adequate professional skepticism resulted in misleading financial reports being presented to the public. As a consequence, the Ministry of Finance sanctioned the auditors for violating audit standards and a lack of diligence(Nurul Hidayati, 2019).

Another concern was also underscored in the late of 2022 by the Wanaartha Existence Prevention Organization in a report addressing instances of audit violations involving public accountant from KAP Crowe Indonesia. This case concerns how a lack of auditor independence can become a serious issue, it undermines the audit quality and impacts on trust of report users. The audit services provided for approximately 5 years from 2014-2019 questioned the independence of auditors with clients, where Indonesia regulates mandatory auditor changes, according to Government Regulation No. 20 of 2015, Article 11 paragraph (1) "Public accountants in Indonesia can only audit a company's financial statements for up to five years in a row. After that, they're required to take a two-year break before working with the same client again, an effort to maintain objectivity and avoid overfamiliarity."(Antoni et al., 2018). The failure of Crowe Indonesia to spot and report these red flags in the company's financial statements raised serious concerns regarding the auditor's competence to remain objective and carry of their role responsibly.

Figure 1.1 Investor Interest in Auditor Reports



Source : IAPI Survey Conducted in Indonesia

The previous auditor's report has been widely regarded as insufficient in meeting the needs of users, as it offered limited transparency and lacked detailed, important information. Audit reports often suffer from being overly lengthy and technical, which can cause readers to skip directly to the auditor's opinion, the section deemed most critical for understanding the actual company's financial standing. This aligns with criticism that traditional audit reporting lacks communicative quality and informative value (Li, 2017). Based on the figure 1.1, only 34% (940 people) investors that comprehensively read the audit report, 32% (880 people) sometimes read the entire information and the remaining 34% (916 people) only read the audit opinion paragraph. This indicates that despite the importance of audit reports for informed decision making, a substantial number of investors may be missing critical insights by not thoroughly reviewing all the provided information, potentially limiting their understanding of a company's financial health.

The traditional audit report was seen as failing short in showing the true quality of the audit (IAASB, 2011). The information that has been reported by auditors turns out cannot satisfy corporate financial statement users who would prefer to have more specific information of each corporation when making decisions (Suttipun, 2019). It didn't give users enough insight into how thoroughly the audit was performed or what the auditor actually found. Therefore in 2015, International Standard on Auditing No. 701, issued by the International Auditing and Assurance Standards Board (IAASB) in response to concerns of audit quality improvement especially responding to various corporate scandals and demands of more informed report by the financial report users. One of the significant shift in the audit report format is the "Communicating Key Audit Matters in the Independent Auditor's Report".

Bringing Key Audit Matters (KAMs) into audit reports has come to be as a major shift in the way audit results are communicated over the last 90 years (Nguyen & Kend, 2019). Users of financial reports can learn more about the most important components of the report and the areas that are most likely to have material misstatements during the audit process by consulting Key Audit Matters (KAM). Three important factors are taken into account when identifying Key Audit Matters, as per No. 1504. The first step is to assess areas that have a significant risk that includes material misstatement or unique risks. Areas requiring substantial management judgment come in second, followed by significant transactions or issues in third. For each Key Audit Matter (KAM), the auditor needs to clearly explain why it was considered important and what was done during the audit to address it (Li, 2017). The requirement has been mandatory in Indonesia since January 1, 2022 and it is expected

to improve how much the auditor's report actually helps users by providing a short explanation that clarifies complex financial information.

By emphasizing the most critical matters, KAM allow readers to better understand areas of the audit that became the greatest concern, thereby supporting their ability to make informed decisions (IAPI, 2023). Communicating Key Audit Matters (KAM) happens after the auditor has taken a full look at the financial statements and reached their overall opinion. It is intended to offer insights into the audit process, rather than serving as a separate opinion on specific issues. Additionally, KAM communication does not replace the disclosures that management is required to make in the financial statements according to the relevant financial reporting framework, nor is it a substitute for other necessary disclosures needed to ensure fair presentation (Dawn Mcgeachy, 2017).

However, it's still unclear whether requiring auditors to include Key Audit Matters (KAMs) in their reports truly adds value or helps bridge the information gap between company management and investors. Just putting KAMs on paper doesn't automatically mean stakeholders are better informed or more confident in the numbers they're reading (Li, 2017). Due to concerns about reliability, auditors might choose to disclose only a minimal number of key issues, which could limit the usefulness of the information provided or conversely, they may choose to provide overly detailed disclosures that could overwhelm the report with excessive content. The use of technical accounting language in KAMs could make the reports difficult for non-accounting professionals to understand. Consequently, KAM disclosures might lead to excessive content, complicate audit reports, and introduce additional costs and

uncertainties ((IAASB), 2012). This has been a point of contention throughout the research, questioning whether the inclusion of Key Audit Matters (KAM) enhances or diminished audit quality. Critics argue that the requirement for auditors to disclose KAMs may increase the cost and effort burdens on auditors, potentially affecting the overall efficiency, effectiveness, and independence of the audit process.

The foundational research for this study is the work of Suttipun (2021), who identified a positive relation between Key Audit Matters (KAM) and audit quality. Findings conclude that communication of KAM is believed to increase the quality of communication and improve the informative value of the audit reports. However, there is still limited research that specifically explain the impact of KAM to Audit Quality in Indonesia. The closest research is presented by Fatin (2024), which states that the longer KAM disclosed in the audit report, the higher the audit quality. This study aligns with agency theory, which highlight that shareholders and debtholders (the principals) are more confident that the information they receive is fairly presented. This reduction in information asymmetry also helps to build stronger sense of credibility around the company's operations, so it's paving the way for better governance and making it harder for management to act in self interest at the expense of others. Consequently, the relationship between information disclosure and how well it could be communicated is vital in ensuring that the interests of all parties involved are adequately represented and safeguarded.

Besides the significant correlations of KAM and Audit Quality, some studies also have found that the disclosure of KAM does not necessarily correlate with improved audit quality and even resulting into negative impact on audit quality.

Research that presented by Li, (2017) in China conclude that the disclosure of KAM did not improve the quality of audit. That for China's newly enacted guidelines for adding key auditing matters are not as informative as regulators anticipated, nor do they significantly affect audit quality. Still, these findings add interesting insight to the ongoing global conversation around the use of key audit matters, offering new perspectives that can help to shape how they're understood and applied in practice. Research conducted by Kitiwong & Sarapaivanich, (2020) also found that there's a weak evidence that Key Audit Matters (KAM) disclosure correlate with audit quality, likely because auditors treated KAM disclosures as a compliance formality, often used generic language, failed to influence audit procedures meaningfully, and were not easily understood or effectively used by financial statement users.

Due to differences in research results across countries, and since this KAMs reporting research is still relatively rare in Indonesia, this study aims to retest and re-examine earlier findings within the Indonesian context. The differences of this research with previous research is the object that focusing on companies listed Indonesia Stock Exchange (BEI) because these entities are subject to SA 701, which requires auditors to include KAM in reports that accompany a full set of general purpose financial statement to give readers a clearer view of the most critical areas the auditor examined. 98.4% of audit reports (from 813 reports) had already included KAM as of January 31, 2023, according to research by the Indonesian Institute of Certified Public Accountants ((IAPI), 2023).

1.2. Research Questions

The Independent Auditor's Report (ISA), which previously only provided an audit opinion, was considered to have limitations in providing important informative value. The existence of limitations in the traditional independent audit report created demands for improvement of audit quality which was then implemented in SA 701. Auditor's role in implementing SA 701 (KAM) puts them in a critical position to improve their ability and competency in understanding of the audit risks and the financial statements itself. By identifying and disclosing Key Audit Matters, auditors could have a deeper explanation of risks and complexities faces by the company and thereby, improving the overall audit quality.

The connection between Key Audit Matters (KAM) disclosures and audit quality remains a relatively underexplored topic in the Indonesian context. Building on this gap and insights from earlier studies, this research sets out to explore the following questions :

1. Does the Length of Key Audit Matters affect audit quality?
2. Does the Number of Issues Disclosed in Key Audit Matters affect audit quality?

1.3. Research Objectives

This research aims to test and empirically prove the impact of Key Audit Matters (KAM) disclosure on audit quality in companies listed on the Indonesia Stock Exchange (IDX) between 2022 and 2023. Based on the problems identified earlier, this study looks for solid, data-driven answers to the following research questions :

1. To test the impact of the Length of Key Audit Matters to audit quality.
2. To test the impact of the Number of Issues Disclosed in Key Audit Matters to audit quality.

1.4. Research Contributions

Research is conducted with the objective of expanding knowledge and enhancing both the public and professionals who can benefit from the findings. This research encounters the potential to provide the following key advantages:

1.4.1. Theoretical Contributions

The results from this research are intended to be used as foundation for future studies exploring Key Audit Matters (KAM), audit quality, and broader topics in the auditing field. Beyond that, the result could also offer real world evidence of how KAM disclosures relate to the quality of an audit. This will contribute to a deeper understanding of how audit standards applied in real world practice.

1.4.2. Practical Contributions

The research provides practical contributions by helping auditors enhance their practices through a better understanding of how Key Audit Matters (KAM) shows audit quality, auditors can improve their focus, communication, and competency, in the lead to higher quality audits. This research also hopes to offer insight into why the implementation of Key Audit Matters is important, so that it will help the user of audit report to make more informed decisions based on clearer and more relevant information presented in the audit report.