

CHAPTER II

LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

2.1. Agency Theory

Agency theory looks at the relationship between two key players, the principal that usually the shareholders and the agent, typically the company's management. In a simple terms, it's about how the people who own the company trust others to run it on their behalf, with the expectation that those managers will act in the owners' best interest (Hendrastuti & Harahap, 2023). However as first proposed by (Fossung et al., 2022), this relationship often comes with a potencial conflict of interest. Which means that agency theory is built on the idea that managers, those that trusted to run the company, might not always make decisions that are fully align with what is best for the owners and shareholders. Meaning that those in charge don't always act in the interests of those they were supposed to represent. Agents may prioritize their own goals, such as personal financial gain or jobsecurity, which can lead to decisions that are not aligned with the principal's objectives. This situation leads to an information asymmetry, as the agent may not fully disclose the information that they has to the principal (Fatin, 2024). As the result, the principal face the risks of the agent withholding critical information or taking actions detrimental to company's long-term performance.

To mitigate these conflicts of interests, an effective monitoring mechanism is needed, one of which is through a quality financial report audit (Yousefi Nejad et al., 2024b). External auditors as an independent party is appointed by the management to analyze and inspect the information of accounting records and report their findings to the shareholders as to whether it was presented fairly in accordance with the standards. However, the effectiveness of auditing in addressing agency problems shaped largely by the depth of the audit process and the auditor's competency in addressing and communicating key findings through the audit report. This is where the disclosure of KAM becomes relevant. By requiring auditors to disclose KAMs, the potential for conflict between the agent (management) and principal (shareholders) is further minimizes, as these disclosure enhance competencies regarding areas of significant judgement and risk in the financial statement ((IAPI), 2023). Several previous research have shown that KAM characteristics such length and specificity can affect audit quality(Fatin, 2024). This reflects the core idea of agency theory perspective, which suggests that better disclosure of KAM can help bridge the information gap between management and stakeholders so that it could improve audit quality and assisting in the resolution of agency problems.

2.2. Communication Theory

Communication is a dynamic and ongoing process in which people create and interpret messages with the goal of receiving a reponse. It entails the exchange of information, ideas, or feelings in the hope that the message will influence or prompt a

reaction from the recipient. In communication theory, the process of creating messages involves intentional construction, selection, and planning of both the form and substance of what is communicated (Griffin et al., 2023). In this research, communication theory provides an important framework for understanding how information is conveyed between auditors and stakeholders, and how this impacts the perception of audit quality. From a communication theory perspective, the audit report is more than just a formal document. It's the auditor's way of telling a story. It's how they share key messages with the company and its stakeholders, helping them understand what was found, what matters most, and where attention should be focused (Jayanti & Fatima, 2023).

The essence of effective communication is ensuring that the messages conveyed by the senders are as clear as possible for the recipients (Detajarutsari et al., 2019). This means that communicators must prioritize clarity and coherence, carefully structuring their messages to be easily understood by their intended audience. The ideas of Key Audit Matters appear to reduce communication problems while enhancing clarity, allowing readers to easily understand the report's main point. The goal is to eliminate any potential misunderstandings, allowing information, ideas, or emotions to be transmitted as accurately as possible from one party to another. Communication theory has been applied in several previous studies due to the distinct nature of KAM reporting compared to traditional audit reports (Suttipun, 2021). Traditional audit reports are often criticized for being difficult to read and comprehend, offering neutral, rather than critical, information, and generally reflecting ineffective communication. In contrast, KAM disclosures introduce a more focused and meaningful way of conveying

important issues, providing clearer and more detailed insights that are easier for users to understand (Detajarutsari et al., 2019).

Previous research investigated into various factors that influence report readability, with a focus on elements that make reports easier or more difficult to understand, such as language complexity, sentence structure, and data presentation. Previous research has also shown that the size of an audit firm influences the readability of audit reports (Jayanti & Fatima, 2023). Larger firms, with their resources and expertise, may produce more understandable reports, whereas smaller firms may struggle to achieve the same level of clarity and accessibility in their reporting. Study that conducted by (Chang & Stone, 2019) concluded that notable differences exists in the readability of audit reports issued by Big 4 and non Big 4 audit firms. Their study highlights that the larger firms tend to deliver audit reports that are clearer and easier to understand than those prepared by smaller firms.

2.3. Key Audit Matters

Key Audit Matters (KAM) are significant risks or issues that auditors identify while auditing the company's financial statements, that auditors believe it is critical for users to understand the audit's context and results. The introduction of Key Audit Matters (KAM) stands out as one of the most impactful changes to SA 701, or Standar Audit 701, which was introduced as a way to address the issues and demand for greater transparency and informative auditing reports in the face of increasing economic uncertainty and business complexity. This standard requires auditors to highlight the

most significant issues that faced while doing the audit process that are critical for financial statement users to understand, which are referred to as Key Audit Matters (KAM) or *Hal Audit Utama*. When making this decision, auditors should consider the following :

- a. Sections of the audit that involve a greater likelihood of material misstatements, or areas classified as significant risks based on the guidelines set out in SA 315. (Revised 2021).
- b. Situations where the auditor must exercise considerable judgment in evaluating parts of the financial statements that rely heavily on management's judgements. For example, accounting estimates that involve a high level of uncertainty.
- c. How audit was impacted by noteworthy transactions or events from the time period.

The length of the Key Audit Matters (KAM) section is often measured by calculating the number of words, a method known as word counting. This measurement is similar with research that conducted by (Suttipun, 2021) and (Jayanti & Fatima, 2023). A longer or the more words are in the KAM section typically implies that the auditor has provided more detailed explanation about the significant audit issues. The higher word count suggests that the auditor is discussing more complex matters, providing more contextual and revealing the procedures through auditor's reponse and reasoning that have been used during the audit process. When the KAM section contains more words, it suggests that the auditor is offering deeper analysis into the audit process, discussing the reasons for identifying certain matters and the audit

responses in greater detail. A more detailed KAM section can reflect greater clarity, professional judgment, and a comprehensive audit process, all of which contribute to the communicative quality of the audit report. However, excessively detailed or unnecessarily elaborate disclosures may obscure the key issues, making it harder for users to identify which matters are most critical. In such cases, too much information can reduce clarity and hinder user understanding, potentially weakening the intended informational value of the KAM. Therefore, while longer disclosures may signal diligence, their usefulness ultimately depends on the auditor's ability to communicate clearly and concisely.

Content analysis, focuses on the number of issues that already written within the section of KAM. This approach helps to assess how many important audit matters are highlighted by the auditor, showing the complexity and focus of the audit. Research that conducted by (Bepari & al, 2023) stated that the majority of earlier research conducted in developing countries has explored the factors that influence the number of Key Audit Matters (KAMs) disclosed in audit reports. A higher number of issues typically indicates a more complex audit, as the auditor has identified several significant areas that requiring attention. This reflects the range of significant risks, uncertainties or critical areas that required auditor's judgment. Auditors who willing to disclose more issues may be more diligent and independent in addressing a broader set of concerns, which could be associated with higher audit quality. This measurement is align with previous research that conducted by (Rahaman et al., 2022) ; (Fatin, 2024).

2.4. Audit Quality

Audit quality stands out to the degree to which an audit accurately assesses and reports the financial position of a firm. While traditional audit reports provide a simple “unqualified or qualifies opinion”, the actual quality of audits exists on a continuum due to variations in managerial discretion, accounting choices, and judgments applied in preparing financial statements (Francis & Wilson, 2023). In essence, audit quality could be inferred from the quality of the audited financial statements, recognizing that there are varying levels of both. Good audit quality is reflected in a high quality financial reports that have low levels of earnings management, indicating that the financial statements contain minimal manipulation and provide more accurate and reliable information. This is driven by the idea is that when the audit is done thoroughly and with high quality, it helps to prevent companies from manipulating their earnings for personal or short term gain (DeFond & Zhang, 2014). High-quality auditors are expected to press their clients to adopt more conservative accounting policies, thereby enhancing earnings quality. Conversely, lower-quality auditors may allow more flexibility in estimates, leading to reduced earnings quality. Thus, by assessing the level of earnings management, a more nuanced understanding of audit quality can be achieved beyond the traditional pass/fail report.

Several proxies could be used to measuring the audit quality, namely material misstatements using restatements, auditor communication using Going Concern opinions, perception-based by market reaction or cost of capital, and any other else.

This research is using Financial reporting quality characteristics through the Modified Jones Model (Jones, 1991) discretionary accruals (DAC) model. Since financial statements reflect management's choices in accruals, auditors play a critical role in evaluating and constraining aggressive accruals to ensure reasonable reporting. (DeFond & Zhang, 2014) stated that Measures of financial reporting quality are often seen as a good way to reflect audit quality. The better the audit, the more confidence we can have that the financial statements genuinely represent the company's actual financial situation taking into account how the company reports its finances and the nature of its business.

$$DA = \left[\frac{TA_{it}}{A_{it-1}} \right] - NDA_{it}$$

$$TA_{it} = NI_{it} - CFO_{it}$$

$$NDA_{it} = \alpha_1 \left[\frac{1}{A_{it-1}} \right] + \alpha_2 \left[\frac{\Delta Rev_{it} - \Delta Rec_{it}}{A_{it-1}} \right] + \alpha_3 \left[\frac{PPE_{it}}{A_{it-1}} \right]$$

Where :

DA = discretionary accruals

TA_{it} = total accruals of firm i in year t

A_{it-1} = total assets of firm i in year t-1

NDA_{it} = non-discretionary accruals of firm i in year t

TA_{it} = total accruals of company i in year t

NI_{it} = net income of company i in year t

CFO_{it} = Cash flow from operations of company I in year t

NDA_{it} = Non-discretionary accruals of company i in year t

A_{it-1} = total assets of company i in year t-1

ΔRev_{it} = change in net sales of company i in year t

ΔRec_{it} = change in net receivables of company i in year t

PPE_{it} = fixed assets of company i in year t

$\alpha_1, \alpha_2, \alpha_3$ = parameters

2.5. Audit Fee

Audit Fee is the remuneration paid to accounting firms and auditors for their services (Ye, 2020). Setting the cost of an audit usually comes down to practical discussion between the company and the audit firm. Both sides need to talk through the scope of work, the complexity, and time involved. Reasonable audit fees are required to ensure auditors carry out their assurance duties effectively and maintain audit quality. Audit Fee is influenced by factors such as task complexity, risk level, auditor expertise, and other professional considerations (Eny & Mappanyukki, 2020). Her findings show that higher audit fees are associated with higher audit quality, implying that higher audit fees increase the likelihood of delivering better-quality audits. In this research audit fees are assessed using natural logarithm of the service fee amounts given to the auditor and disclosed in the company's annual report. In accordance with PP No. 2 of 2016 Article 5 paragraph 2 concerning the basic policy in calculating the remuneration for services provided, namely:

- 1) The amount of the standard hourly charge out rate for each level of auditor staff;

- 2) Pricing policy for determining prices that are different from the standard fee rate;
- 3) Method of determining the total amount of service fees to be billed to the entity as stated in a Letter of Engagement.

2.6. Audit Tenure

Audit tenure refers to the duration of the professional relationship between an auditor and a company (Martani et al., 2021). As the tenure lengthens, the auditor's independence may diminish, making it necessary to rotate auditors periodically to preserve objectivity and impartiality. The main purpose behind rotating audit partners is to strengthen audit quality by keeping both real and perceived independence intact. It also brings a fresh set of eyes to the audit, helping to spot issues that might have been overlooked. This approach reminds auditors to stay alert to the subtle pressures that could cloud their judgement and put their objectivity at risk (Salman & Setyaningrum, 2023). These pressures may slowly weaken their objectivity, both when issuing audit reports and during the audit process itself. This suggests that when an auditor and client have worked together for too long, their close relationship may jeopardize auditor's independence and impartiality.

Audit tenure in this research is measured by the duration, typically in years, that an external auditor or audit firm has continuously provided audit services to the same company. This metric reflects how long the auditor has been working with the same client, where a longer tenure may indicate a deeper familiarity with the company's

financial report and operational practices. However, extended audit tenure may also raise concerns regarding the auditor's independence as prolonged engagements could compromise objectivity. By incorporating audit tenure as a variable, this research aims to assess how the length of the auditor-client relationship influences audit quality.

2.7. Corporate Size

Corporate size reflects the extent of a company and became an indicator of its condition and characteristics. Company size is a major indicator of firm performance, with larger firms getting more diversified, better managed, and more risk tolerant. On the other hand, Smaller firms often face a tougher time closing the information gap between themselves and stakeholders, which can make them seem less transparent or reliable compared to larger, more established companies (Behrmann et al., 2025). Research conducted by (Nugrahanti & Darsono, 2014), Firm size is recognized as a key factor influencing audit quality because as a company grows, the likelihood of agency conflicts also rises, which can lead to a greater demand for varying levels of audit quality. In this research Company Size is measured by using the total assets of the company, indicating that the larger the company, the more complex the operational activities and require a higher quality auditor.

In this research corporate size is measured by calculating the total asset of the company, which includes cash, investments, property, equipment, inventory, and other assets reported on the company's balance sheet. By measuring total asset, this research wants to capture the overall financial capacity and operational scale of the company.

Larger firms, with greater total assets, tend to have more complex operations and face distinct risks compared to smaller firms, potentially influencing the audit process and the resulting audit quality.

2.8. Corporate Profitability

Corporate profitability is a way to measure how well a company turns its resources such as sales, asset, equity into actual profits over a specified period (Prapanca & Kumalasari, 2023). It serves as a key indicator of financial health, reflecting how efficiently a company converts sales into profits. Profitable companies are often seen as financially stable, which may lead auditors to focus less on concerns like financial misstatement. However, high profitability can also raise the risk of earnings management, as companies might be tempted to manipulate financial figures to meet market expectations. On the other hand, declining or erratic profitability may increase the likelihood of audit scrutiny, as financial distress or operational inefficiencies can heighten the risk of misreporting. Auditors rely on profitability measures, such as Return on Assets (ROA), to assess the capacity of business to generate profit or gains from its assets (Pratama et al., 2024). ROA represents the profitability ratio calculated using the following formula:

$$ROA = \frac{Net\ Profit}{Total\ Assets} \times 100\%$$

2.9. Corporate Solvability

Corporate solvability is all about a company's strength to handle its long-term debts and stay financially steady over time. According to Laksmi & Sukirman (2020),

companies that are heavily rely on debt and having a weak financial health are more often turn to auditors with strong reputation known for their high level of independence. This is because financially distressed companies face greater concern from shareholders and creditors, who rely on the credibility of audited financial statements to assess the company's viability. According to (Wibowo, 2016), the Debt to Equity Ratio is used to assess the degree in which, company's debt is supported by its equity. The Debt to Equity ratio is worked out by using this formula :

$$\text{Debt to Equity} = \frac{\text{Total Debt}}{\text{Total Shareholders Equity}} \times 100\%$$

2.10. Previous Research

Table 2.1 Summary of Previous Research

No	Researcher	Variable	Subject	Result
1	(Suttipun, 2021)	Dependent variable (Y) : Audit Quality Independent variables (X): X_1 : KAMs reporting X_2 : Audit Fees X_3 : Audit Tenure X_4 : Audit Experience X_5 : Auditor Firm Size X_6 : Audit Independence	Companies listed on the Stock Exchange of Thailand (SET).	1. There was a positive significant relationship between KAMs reporting and audit quality. 2. There is an impact of audit tenure, auditor firm size, audit independence,

		Control variables: 1. Corporate size 2. Corporate profitability 3. Corporate risk 4. Corporate age		corporate size and corporate risk on audit quality.
2	(Shamsuddin & Masdor, 2020)	Dependent variable (Y) : Audit Quality Independent variable (X): KAM Control Variables : 1. Profitability 2. Leverage 3. Company size	Malaysian PLCs available in Main Market on Bursa Malaysia database	The more Key Audit Matters (KAMs) an auditor discloses in the report, the more it tends to reduce unusual or questionable accounting adjustments. This, in turn, reflects stronger audit quality among publicly listed companies in Malaysia.
3	(Li, 2017)	Dependent variable (Y) : Y ₁ : Audit Quality	Companies listed in China Stock Market	Key Audit Matters did not demonstrate a higher audit quality

		Y₂ : Market Reaction Independent variable (X): KAM Control Variables : 1. Profitability (ROA) 2. Firm Size 3. Annual Report Delay 4. Market to book ratio 5. Leverage (Debt) 6. Variation in Net Income 7. IFRS 8. Crosslisted	and Accounting Research Database	
4	(Fatin, 2024)	Dependent variable (Y) : Y₁ : Audit Quality	Financial Sector Companies Listed on the Indonesia Stock	1. The number of KAM had a significant

		Independent variable (X): X_1 : Amount of KAM X_2 : Reason of the disclosure of KAM X_3 : Readability of KAM X_4 : Specificity of KAM disclosure X_5 : KAM's privilege	Exchange in 2022-2023	positive effect on audit quality 2. The reason for KAM had no significant effect 3. The readability of KAM and the specificity of KAM disclosure have no significant effect on audit quality. 4. The specialty of KAM has a significant positive effect on audit quality.
5	(Yoga & Dinarjito, 2021)	Dependent Variable (Y) : Communicative Value In Audit Report	Systematic literature review of the latest articles 2012-2021	The research supports the implementation plan of SA 701 in Indonesia and it can increase the communicative value

		Independent Variable (X) : The Disclosure of KAM		of independent audit reports.
6	(Coram & Wang, 2020)	Dependent Variable (Y) : Audit expectation gap Independent Variable (X) : X_1 : The Disclosure of KAM X_2 : Accounting Standard	Non-professional report users in Australia	The disclosure of KAMs in the audit report does not have impact on the audit expectation gap
7	(Kitiwong & Sarapaivanich, 2020)	Dependent variable (Y) : Y_1 : Audit Quality Independent variable (X): X_1 : The number of disclosed KAMs	Companies listed on the Stock Exchange of Thailand (SET).	1. There is a weak evidence that KAMs disclosure improved audit quality because auditors putting more effort into their audits and audits being

		X_2 : The most common types of disclosed KAMs		performed better after the introduction of KAMs. 2. The amount of Key Audit Matters (KAMs) disclosed and the types most frequently reported don't necessarily reflect how strong or reliable the audit actually is.
8	(Bepari & al, 2023)	Dependent variable (Y) : Y_1 : Audit Quality Independent variable (X): X_1 : The number of KAMs	Companies annual report that listed in Dhaka stock exchange 2018-2021	1. The adoption of KAMs does improve audit quality 2. The number and characteristics of KAMs are

		X_2 : The reasons disclosed by auditors for KAMs X_3 : The readability of KAMs X_4 : Disclosure specificity X_5 : Idiosyncrasy of KAMs		associated with audit quality
9	(Wei & al, 2023)	Dependent variable (Y) : Y_1 : Audit Quality Y_2 : The level of provision for impairment of bank loans Independent variable (X):	Commercial banks in China	1. Disclosure of KAMs improves loan impairment provisions in commercial banks, preventing management from manipulating earnings and improving

		X_1 : The disclosure of KAMs		financial information quality. 2. The loan impairment provision helps improve audit quality in terms of new reporting standards.
10	(Zeng et al., 2021)	Dependent variable (Y) : Y_1 : Audit Quality Independent variable (X): X_1 : KAM Number X_2 : Reason of the disclosure of KAM X_3 : Readability of KAM X_4 : Specificity of KAM disclosure	Companies in China Stock Market and Accounting Research (CSMAR) database.	1. Audit quality increases significantly following the KAM rule. 2. The number of KAMs, disclosure characteristics serve as a way for auditors to express their concerns about how reliable a

		X_5 : KAM's Length Control Variables: 1. Firm Size 2. Cash flow from operation 3. Leverage 4. Turnover 5. Sales Growth 6. Big 4 7. Industry Type		client's earnings are, how much effort they put into the audit, and how likely to issue modified opinions.
11	(Bepari M. K., 2024)	Dependent variable (Y) : Y_1 : Audit Efforts Y_2 : Audit Fees Y_3 : Audit Quality Y_4 : Audit Report Transparency Independent variable (X): X_1 : KAMs reporting	Stakeholders (Audit Partners, CFOs, and regulators)	1. KAMs reporting has increase audit effort but it does not lead to more transparent KAMs reporting. 2. KAMs reporting may have little impact on audit fees.

				3. The requirement to report Key Audit Matters (KAMs) has pushed auditors to increase their audit performance. 4. KAMs reporting hasn't fully lived up to its goal of making audit reports more transparent partly because auditors often face pressure or limitations from audit committees and boards of directors about what they can actually share.
--	--	--	--	--

2.11. Hypothesis Development

The length of Key Audit Matters refers to the amount of narrative text used by auditors to describe each key issue identified during the audit. Longer KAM disclosures may indicate that the auditor encountered more intricate accounting estimates or high risk areas requiring greater attention and elaboration. Several studies have found that the longer KAMs significantly influence the audit quality. Research conducted by (Zeng et al., 2021) conclude that the length of Key Audit Matters (KAMs) reported in China is significantly related to audit quality that measured by several measurement of creative accounting. Another study found a significant relationship between KAM reporting and audit quality, suggesting that disclosures reflecting the auditor's engagement with the client's financial statements may influence how the quality of the audit is perceived or assessed (Suttipun, 2021). Somehow, the introduction of KAM turned out to has no influence on the quality of audit (Khuong et al., 2024).Based on theoretical explanations and descriptions of previous research, therefore the first hypothesis of this research is :

H1: The length of the disclosure of KAM significantly impacts the audit quality

The number of Key Audit Matters (KAM) reflects the amount of the audit risks associated with the client. Key Audit Matters are typically areas that require significant auditor attention because they involve higher levels of complexity, judgment, or estimation. Several research have found significant relationship

between the number of Key Audit Matters and audit quality. (Shamsuddin & Masdor, 2020) finds that the introduction of KAMs reporting through calculating the number of issues in KAM has had a significant impact on the audit quality. In this context, the number of KAMs serves as a signal of audit competency, which contributes to overall audit quality. (Rahaman et al., 2023) also observed that the number of Key Audit Matters (KAMs) disclosures, may reflect variations in audit practices or professional judgment in presenting significant audit issues. These disclosures could indicate the auditor's engagement with complex areas of financial reporting and serve as a communication tool for stakeholders. However, number of KAM has also been found to have no impact on audit quality (Li, 2017). Therefore, based on theoretical perspectives and insights from prior research, the second hypothesis of this study is formulated as follows :

H2: The number of issues disclosed in KAM significantly impacts the audit quality

2.12. Conceptual Framework

