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RESEARCH ARTICLE

Enhancing Communicative Value in Audit Reports: The Impact of Key Audit Matters on Report Readability and Tone in Thailand

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ABSTRACT

This study explores the effects of Key Audit Matters (KAMs) in auditor reports following updates to standards by the Thailand Federation of Accounting Professions (TFAC), aligned with the International Standards on Auditing ISA 700 (Revised) and ISA 701. Analyzing financial statements from firms listed on The Stock Exchange of Thailand between 2015 and 2017, this research assesses the impact of KAM disclosures on the readability and tonal aspects of audit reports. Our analysis, applying the Gunning Fog Index for readability and Loughran and McDonald's sentiment lexicons for tone, suggests significant enhancements in the communicative effectiveness of audit reports post-implementation. KAMs contribute to a more informative and firm-specific narrative, addressing previously identified expectation and information gaps in auditor communications. The findings underscore the transformative role of KAMs in enhancing transparency and usefulness of audit reports for stakeholders, supporting the IAASB's objectives in revising audit reporting standards.

INTRODUCTION

The auditor's report serves as the fundamental channel of communication between auditors and users of financial statements (PCAOB, 2017). It offers an independent and professional assessment of whether the financial statements of the company under audit accurately reflect the company's financial position (Boolaky & Quick, 2016). However, following the major financial scandals and company collapses in the early 21st century, various stakeholders, especially investors, have raised concerns about the limited communicative effectiveness of auditor's reports, despite audits being conducted by large firms (Christensen, Glover, & Wolfe, 2014; Boolaky & Quick, 2016; Pinto and Morais, 2018).

The International Auditing and Assurance Standards Board (IAASB) attributes these concerns to expectation and information gaps. The IAASB explains an expectation gap as the discrepancy between user expectations from the auditor and the actual financial audit, and an information gap as the disparity between the information users deem necessary for making informed decisions and what is provided in audited financial statements or other publicly accessible information (IAASB, 2011; Pinto and Morais, 2018).

Users also criticize the conventional model of audit reports for their standardized format and content, which often results in reports that lack usefulness, informativeness, and transparency (Gutierrez, Minutti-Meza, Tatum, & Vulcheva, 2018; Asare & Wright, 2012; Church et al., 2008; IAASB, 2011). Although auditors hold substantial information about the company being audited, it is typically condensed into a uniform one-page document. Thus, audit reports are generally perceived as boilerplate documents, delivering minimal company-specific information and viewed merely as pass/fail evaluations.

To address the call for more detailed and informative audit reports, the IAASB introduced the International Standard on Auditing (ISA) 700 (Revised): Forming an Opinion and Reporting on Financial Statements in January 2015. This revision introduces several alterations, including new phrasings to clarify the responsibilities of management and auditors and details on the audit's scope and methodology (Gold, Gronewold, & Pott, 2012; IAASB, 2015a). Fiona Campbell, a partner at Ernst & Young (EY) Australia and an IAASB member, stated that the revamped auditor's reports aim to deepen stakeholders' understanding of financial statement audits (EY, 2015).A pivotal update in the audit reports is the mandate for auditors to disclose key audit matters (KAMs), which are issues deemed significantly crucial in the financial statement audit based on the auditor's judgment. The IAASB also issued ISA701: Communicating Key Audit Matters in the Independent Auditor's Report, which provides guidance on the articulation and presentation of KAMs (IAASB, 2015b).

In Thailand, the Thailand Federation of Accounting Professions (TFAC) has adopted TSA 700 (Revised) and TSA701, in line with ISA700 (Revised) and ISA701, effective for audits of financial statements for listed companies for periods ending on or after December 31, 2016 (TFAC, 2016a, 2016b).

The inclusion of KAMs in audit reports potentially increases their communicative value by allowing auditors to share more detailed, firm-specific information and move away from generic language. This study evaluates whether the communication value of audit reports has been enhanced following the implementation of TSA700 (Revised) and TSA701, with a specific focus on whether there is an improvement in the second year of disclosing KAMs compared to the first. This study's assessment of communication value includes both the tone and readability of the audit reports, where readability assesses the clarity of the message conveyed, and tone reflects the emotional quality of the communication (Henry, 2008).

The findings of this study contribute to the auditing literature by validating whether the revised audit reports that require the disclosure of KAMs achieve the increased communicative value anticipated by the IAASB. Furthermore, the empirical results obtained can guide the IAASB in setting further standards relating to audit reporting. Other standard-setting bodies and regulatory authorities may also use this evidence to formulate standards for other reporting formats. The remainder of the paper is structured as follows: the next section delineates the theoretical framework leading to the development of hypotheses; Section 3 outlines the research methodology; Section 4 discusses the empirical results; and the final section concludes with the study's conclusions and recommendations.

THEORETICAL BACKGROUND AND HYPOTHESIS DEVELOPMENT

Key Audit Matters (KAMs)

KAMs are defined by the IAASB as "Those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance" (IAASB, 2015b). The requirement for auditors to communicate KAMs in their audit reports is a result of the implementation of ISA700 (Revised) and ISA701. Both standards originate from an attempt of IAASB to improve the communication value of the audit report in order to meet the demand of financial statement users.

ISA701 provides guidelines to communicate KAMs in the audit report in the following manner (IAASB, 2015b):

- KAMs shall be disclosed in a separate section of the auditor's report under the heading "Key Audit Matters."
- Each KAM shall be disclosed using an appropriate subheading.
- The order of presentation of individual matters in the KAM section is a matter of professional judgment.
- The adequacy of the description of a KAM is a matter of professional judgment.
- Auditors are suggested to limit the use of highly technical auditing terms in order to enable intended users who do not have a reasonable knowledge of auditing to understand the basis for the auditor's focus on specific matters during the audit.
- Auditors shall provide useful information in a concise and understandable form.

KAMs and Communication Value of the Audit Report

Communication value, audit report readability, and KAMs

According to communication theory, an audit report possesses communicative value when the financial statement users can grasp the message the auditors intend to convey (Smith and Smith, 1971). The evaluation of communication value within the realm of financial reporting has traditionally employed both subjective and objective methods. The subjective method involves querying the information provider about their perception of the recipient's ability to understand and use the information and testing the recipient's ability to interpret the intended meanings of the financial statements. More objectively, the "readability" of the audit report offers a straightforward and measurable approach to assess communication value (Smith and Smith, 1971).

Readability refers to the ease of comprehension or understanding of written matter (Smith and Smith, 1971). Improved audit report readability is likely to reduce the expectation and information gaps between auditors and financial statement users which, in turn, enhances the communication value of the audit report. According to ISA700, auditors have flexibility in communicating information in their audit reports. It is found that when auditors communicate in a manner that is easy for financial statement users to understand, this improves the readability of the audit report (Smith, 2016). As auditors also have the flexibility to disclose KAMs in their audit reports, the audit report with KAMs disclosed is likely to be more readable than one without KAMs. Then, the first hypothesis of this study can be stated in the following manner:

H1a: The readability of the audit report after the implementation of ISA700 (Revised) in which KAMs are disclosed improves when compared to that prior to the implementation of ISA700 (Revised) in which no KAM is disclosed.

Communication value, audit report tone, and KAMs

Readability effectively assesses how well an audit report conveys its intended message to financial statement users. However, it does not delve into the substance of the message conveyed. Tone, on the other hand, captures the emotional quality or "affect" of the message, providing additional insights into the communicative value of the audit report (Henry, 2008).

The tone of the audit report may be classified as negative, positive, or neutral based on the presence of respective types of words within the text (Loughran & McDonald, 2011). Prior to the revisions of ISA700 (Revised), audit reports typically employed a standardized language, which limited the scope for varying tone. Post-revision, with the introduction of Key Audit Matters (KAMs), auditors have greater flexibility in language use, thus allowing for a more varied tone. Given that KAMs often highlight areas of significant risk or potential material misstatement, it is expected that the tone of audit reports disclosing KAMs would generally be more negative compared to those without such disclosures.

H1b: The tone of the audit report after the implementation of ISA700 (Revised) in which KAMs are disclosed are more negative than that in audit reports prior to the implementation of ISA700 (Revised) in discloses no KAMs are disclosed.

Audit report readability and tone in the second year of disclosing KAMs

Following the initial year of implementing Key Audit Matters (KAMs) in audit reports, auditors receive valuable feedback from financial statement users, which can significantly influence subsequent reporting practices. Notably, as highlighted in the Financial Reporting Insights from December 2018 by Ernst and Young (EY), users have expressed concerns that while the revised audit reports are more detailed and informative, their increased length and the complex language used to describe KAMs can be challenging, particularly for less sophisticated investors (EY, 2018). Such feedback is instrumental for auditors who aim to enhance the accessibility and effectiveness of their reports.

In response to these critiques, it is reasonable to anticipate that auditors will strive to refine their communication approach in the following years. This likely includes efforts to condense the content and simplify the language used in the audit reports, making them more concise and understandable without compromising the depth of information provided about KAMs. This adaptive response aligns with the continuous improvement practices typical within the auditing profession and aims to bridge the gap between comprehensive disclosure and user-friendly communication. Therefore, the second research hypothesis of this study posits that:

H2a: There is an improvement in the readability of the audit report in the second year of the implementation of ISA700 (Revised) in which KAMs are disclosed as compared to audit reports in the first year.

For the subsequent year, as the definition and the guidelines for determining KAMs are unchanged, we do not expect any change in the audit report tone. However, we examine whether there would be any evidence that the tone of the audit report in the second year is different from that in the first year. Therefore, we propose the following hypothesis:

H2b: The tone of the audit report in the second year of the implementation of ISA700 (Revised) in which KAMs are disclosed is different from that in the audit report in the first year.

METHODOLOGY

To examine the communication value of key audit matters disclosed in the audit report, the companies listed on The Stock Exchange of Thailand (SET) during the period 2015–2017 were used as the sample in this study. Audit reports in the English version of the sample companies are used to analyze tone and readability. Moreover, audit reports with a disclaimer of opinion are excluded from the sample as well as audit reports that do not disclose KAMs in 2016 and 2017. In analyzing audit report readability and tone, two paragraphs in the audit report—Responsibility of Management and Those Charged with Governance for the Financial Statement and Auditor's Responsibilities for the Audit of the Financial Statements—are excluded to control for the difference in the form of the audit report prior to and after the implementation of ISA700 (Revised). The final sample includes 631 companies for the year 2015, 645 companies for the year 2016, and 646 companies for the year 2017, totaling 1,922 firm-year observations. Firm-specific data is collected from company annual reports.

Using those corporate annual reports during the period 2015–2017, communication value judged by tone and readability are used as the dependent variable. Following a previous study (Smith, 2016), the FOG index is used to measure readability. The measure is developed by Robert Gunning (Gunning,

1952) and is widely used to measure readability of various kinds of financial text such as MD&A, annual reports, and audit reports (Li, 2008; De Franco et al., 2015; Smith, 2016). The FOG index considers the number of words per sentence and the percentage of complex words (words with three syllables or more) in evaluating the readability of a text. A high FOG index indicates that the text is complex and less readable, thereby indicating low communication value. While tone is determined by using the number of positive and negative words in the text, positive and negative words are based on the Loughran and McDonald word lists available at https://sraf.nd.edu/textual-analysis/resources/. The higher the score, the more positive the tone of the text. This measure is used in various studies such as Henry (2008); Matsumoto, Pronk, and Roelofsen (2011), and Smith (2016).

KAM and KAMSECOND serve as the independent variables. The variable KAM is assigned a value of one for audit reports from 2016 and 2017—years when KAMs were required following the revision of ISA700—and zero for reports from 2015, a year without such disclosure requirements. It is anticipated that reports containing KAMs will be more readable but may exhibit a more negative tone, leading to an expected negative significance for the KAM coefficient. KAMSECOND is assigned a value of one for reports from 2017, marking the second year of KAM disclosures, and zero for 2016 reports, the initial year of such disclosures. The hypothesis suggests that reports from the second year will show improved readability, thus expecting a negative significance for the KAMSECOND coefficient in terms of readability. No significant change is anticipated in tone between the first and second years of KAM reporting, thus no significant impact of KAMSECOND on tone is expected. Control variables in this study include firm size, market value, age, earnings volatility, group structure, acquisition activity, equity issuance, audit firm, and industry affiliations (Smith, 2016). Table 1 in the study outlines the methods used to measure these variables.

Table 1: Variables and Measurement

Dependent variables	**Notation**	**Measurement**
Readability	READABILITY	(Words per sentence + percent of complex word) x 0.4
Tone	TONE	(Positive – Negative) / (Positive + Negative)
Independent variables		
Kam	KAM	1 = if the audit reports are of years 2016 and 2017 and 0 = if the audit reports are of year 2015
Kamsecond	KAMSECOND	1 = if the audit reports are of year 2017 and 0 = if the audit reports are of year 2016
Control variables		
Firm size	SIZE	Logarithm of total assets at the end of year t
Market value	MB	Market value at the end of year t/book value at the end of year t
Age	AGE	Number of years since the company's IPO at the end of year t
Earning volatility	EARNING_VOL	Standard deviation of earnings over the five year period at the end of year t
Group	NBSEG	Logarithm of the number of companies in a group
Acquisition activity	ACQUISITION	Dummy variable, 1 = acquisition expense is reported in financial statement of year t, and 0 otherwise
Equity issuance	SEO	Dummy variable is 1 if the company issues an equity offering in year t, and 0 otherwise
Audit firm	BIGN	Dummy variable is 1 if the company's auditor is from one of the big four in year t, and 0 otherwise

Dependent variables	Notation	Measurement
Audit firm of company group	COMBINED-OP	Dummy variable is 1 if the company's auditor is from the same audit firm as the company group, and 0 otherwise
Industry	INDUSTRY	1 = Industrials, 2 = Financials, 3 = Property and Construction, 4 = Technology, 5 = Resources, 6 = Services 7 = Agro and Food Industry, 8 = Consumer products, 9 = Companies in the Market for Alternative Investment)

The models used in the regression analysis to test the hypotheses are given below.

KAMs, audit report readability, and tone (H1a and H1b)

The following models are used to Test H1a and H1b.

$$READABILITY_i = \beta_0 + \beta_1 KAM_i + \beta_2 SIZE_i + \beta_3 MB_i + \beta_4 AGE_i + \beta_5 EARN\_VOL_i + \beta_6 NBSEG_i + \beta_7 ACQUISITION_i + \beta_8 SEO_i + \beta_9 BIGN_i + \beta_{10} COMBINED\_OP_i + INDUSTRY_i + \varepsilon_i$$

$$TONE_i = \beta_0 + \beta_1 KAM_i + \beta_2 SIZE_i + \beta_3 MB_i + \beta_4 AGE_i + \beta_5 EARN\_VOL_i + \beta_6 NBSEG_i + \beta_7 ACQUISITION_i + \beta_8 SEO_i + \beta_9 BIGN_i + \beta_{10} COMBINED\_OP_i + INDUSTRY_i + \varepsilon_i$$

Audit report readability and tone in the second year of disclosing KAMs (H2a and H2b)

The following models are used to examine whether the readability and tone of the audit reports change in the second year of reporting KAMs.

$$READABILITY_i = \beta_0 + \beta_1 KAMSECOND_i + \beta_2 SIZE_i + \beta_3 MB_i + \beta_4 AGE_i + \beta_5 EARN\_VOL_i + \beta_6 NBSEG_i + \beta_7 ACQUISITION_i \beta_8 SEO_i + \beta_9 BIGN_i + \beta_{10} COMBINED\_OP_i + INDUSTRY_i + \varepsilon_i$$

$$TONE_i = \beta_0 + \beta_1 KAMSECOND_i + \beta_2 SIZE_i + \beta_3 MB_i + \beta_4 AGE_i + \beta_5 EARN\_VOL_i + \beta_6 NBSEG_i + \beta_7 ACQUISITION_i + \beta_8 SEO_i + \beta_9 BIGN_i + \beta_{10} COMBINED\_OP_i + INDUSTRY_i + \varepsilon_i$$

RESULTS

Descriptive Statistics

Tables 2 and 3 present the descriptive statistics for the sample companies.

Table 2: Mean values of continuous variables

Variables	2015 (n = 631)	2016 (n = 645)	2017 (n = 646)
READABILITY	33.99	22.20	22.38

TONE	-0.28	-0.73	-0.75
SIZE	6.19	6.43	6.59
MB	2.16	2.51	2.68
AGE	18.92	19.60	20.41
EARN_ VOL	551,230.95	540,775.20	759,665.47
NBSEG	1.48	1.68	1.92

Table 2 indicates that the mean value of the FOG measure—the measure of audit report readability—reduces in 2016 and 2017 compared to that in 2015. This indicates that the readability of an audit report in which KAMs are disclosed after the implementation of ISA700 (Revised) is higher than that in an audit report prior to the implementation of ISA700 (Revised). In addition, the mean value of tone—the measure of audit report tone—becomes more negative in 2016 and 2017 compared to that in 2015. This presents the evidence that the tone of an audit report after the implementation of ISA700 (Revised) in which KAMs are disclosed is more negative than that prior to the implementation of ISA700 (Revised).

Table 3: Frequency of dummy variables

Variables	Value	2015 (n = 631)		2016 (n = 645)		2017 (n = 646)	
		No.	%	No.	%	No.	%
ACQUISITION	1	57	9.0	75	11.6	70	10.8
	0	574	91.0	570	88.4	576	89.2
SEO	1	187	29.6	152	23.6	161	24.9
	0	444	70.4	493	76.4	485	75.1
BIGN	1	350	55.5	388	60.2	397	61.5
	0	281	44.5	257	39.8	249	38.5
COMBINED_OP	1	466	73.9	483	74.9	497	76.9
	0	165	26.1	162	25.1	149	23.1

Table 3 provides the descriptive statistics of dummy variables. The results suggest that most sample companies have no acquisition activity and do not issue stock offerings over three years. Their financial statements are audited by one of the big four auditing firms and their auditors are from the same auditing firm as those of the company groups.

Multivariate Results

KAMs and audit report readability and tone (H1a and H1b)

Table 4: Multivariate results

	(1) READABILITY		(2) TONE	
	β	t-value	β	t-value
)Constant(	20.91	20.749***	-.092	-2.119**
KAM	-12.37	-32.060***	-0.453	-27.372***
SIZE	2.02	14.558***	-0.041	-6.950***
MB	0.06	0.987	0.000	0.028

AGE	0.03	1.978**	0.000	1.975**
EARN_VOL	0.00	-1.244	0.000	0.026
NBSEG	-0.05	-1.616	-0.001	-0.411
ACQUISITION	-1.85	-3.078***	0.037	1.424
SEO	-0.23	-0.557	-0.005	-0.289
BIGN	-0.11	-0.295	0.082	4.967***
COMBINED_OP	2.28	5.050***	-0.014	-0.715
INDUSTRY	-0.25	-3.158***	0.002	0.593
R^2	42.5%		31.1%	
N	1922		1922	

***p < 0.01, **p < 0.05, p < 0.10

Column (1) of Table 4 presents the regression results for testing H1a. The coefficient of KAM is negative and significant (β = -12.37, p < 0.01). This indicates an improvement in the readability of the audit report after the implementation of ISA700 (Revised) in which KAMs are disclosed compared to that prior to the implementation of ISA700 (Revised) in which KAMs are not disclosed. Therefore, H1a is supported. The results also reveal that the audit report of larger firms (SIZE), older firms (AGE), firms with combined opinions (COMBINED_OP) are less readable. Interestingly, the audit report of firms that have acquisition activity (ACQUISITION) are more readable than firms without acquisition activity. It is also found that industry (INDUSTRY) affects readability.

The regression results for testing H2a are presented in Column (2) of Table 4. The coefficient of KAM on TONE is negative and significant (β = -0.453, p < 0.01). This indicates that the tone of the audit report after the implementation of ISA700 (Revised) in which KAMs are disclosed is more negative than that in the audit report prior to the implementation of ISA700 (Revised) in no KAMs are disclosed. Therefore, H1b is supported. The results also indicate that the tone of the audit report of larger firms (SIZE) is more negative than that of smaller firms. In addition, the audit report of older firms (AGE) and firms whose financial statements are audited by one of the big four auditing firms (BIGN) is found to have a more negative tone than younger firms and firms audited by non-big four auditing firms.

Audit report readability and tone in the second year of disclosing KAMs (H2a and H2b)

Table 5: Multivariate results

	(1) READABILITY		(2) TONE	
	β	**t-value**	**β**	**t-value**
)Constant(	14.85	20.667***	-0.546	-11.283***
KAMSECOND	-0.04	-0.153	-0.017	-1.066
SIZE	1.16	11.660***	-0.048	-7.256***
MB	0.04	1.288	0.002	0.931
AGE	0.02	1.933*	0.002	4.138***

EARN_VOL	0.00	-0.828	0.000	-0.747
NBSEG	-0.02	-0.994	0.000	-0.174
ACQUISITION	-0.97	-2.559**	0.011	0.429
SEO	-0.49	-1.766*	0.010	0.514
BIGN	-0.15	-0.609	0.063	3.778***
COMBINED_OP	0.91	3.126***	0.024	1.204
INDUSTRY	-0.16	-3.466***	0.004	1.188
R^2	17.7%		5.7%	
N	1,291		1,291	

***p < 0.01, **p < 0.05, p < 0.10

Column (1) of Table 5 presents the results for testing H2a. The coefficient of KAMSECOND on FOG is not statistically significant. This result indicates that the readability of the audit report in the first and second years is not different and, thus, does not support H2a. The results of firm-specific control variables are similar to the results presented in Table 4. SIZE, AGE, and COMBINED_OP are found to have a positive effect on READABILITY. These results indicate that larger firms, older firms, and firms with combined opinions have less readable audit reports. Moreover, the coefficients of ACQUISITION and SEO are negative, thereby indicating that firms that have acquisition activity and issue equity offerings have more readable audit reports. It is also found that industry (INDUSTRY) affects the readability.

Column (2) of Table 5 reports the results for testing H2b. The coefficient of KAMSECOND is not statistically significant. This suggests that there is no difference in the tones of the audit reports in which KAMs are disclosed for the first and second years. Therefore, H2b is not supported. The results also indicate that the tone of the audit report of larger firms (SIZE) is more negative than that of smaller firms. Moreover, the audit report of older firms (AGE) and firms audited by one of the big four auditing firms (BIGN) is found to have a more negative tone than younger firms and firms audited by non-big four auditors.

CONCLUSIONS AND RECOMMENDATIONS

The findings of this study indicate that including Key Audit Matters (KAMs) in audit reports enhances their readability, suggesting that the revamped reports are more communicatively effective than their predecessors. Moreover, the study reveals that reports disclosing KAMs tend to have a more negative tone, which implies that auditors use such language to effectively convey risks associated with the audited entities. This indicates that when auditors have the flexibility to craft their messages, they choose language that not only is easier for users to comprehend but also aptly captures the essential information about underlying risks.

This research makes a significant contribution to the field of audit literature by providing empirical evidence on the communicative benefits of disclosing KAMs in audit reports. Furthermore, the findings offer valuable insights for standard-setters and regulators, showing that audit reports that grant auditors the leeway to tailor their communication are clearer and avoid generic boilerplate language. This flexibility allows auditors to express critical risk-related information more effectively, enhancing the overall quality and utility of the audit report for its users.

AUTHOR CONTRIBUTIONS

Amonlaya Kosaiyakanont conceptualized and designed the project, Worraphan Trakarnsirinont did the data collection, and interpretation. Duraya Sukthomya did the data collection and developed a comprehensive conceptual framework. Wisuttorn Jitaree drafted the manuscript and revised the manuscript. All authors read and approved the final manuscripts.

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No potential conflict of interest was reported by the author(s).

DATA AVAILABILITY STATEMENT

The data substantiating the findings of this study are obtained in the Thailand audited published financial statements from the Stock Exchange of Thailand official website of at https://www.set.or.th/en.

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