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Audit quality and earnings management after communicating Key Audit Matters (KAMs) in the UAE – audacity and auditors' perspectives

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Abstract

Research Question: Does the introduction of Key Audit Matters (KAMs) increase audit quality and reduce agency cost associated with it? Does the introduction of KAMs decrease Earnings Management (EM) and agency cost associated with it?

Motivation: There have been many studies in the past few years testing the impact of KAMs on the quality of the audit and EM in the developed economies like the United States and United Kingdom, however very few studies exist in the context of the UAE. Moreover, many studies on this topic uses quantitative techniques whereas this study employs qualitative method of interview to judge the perception of auditors about the audit quality and EM in the UAE after the introduction of KAMs.

Idea: The research seeks the perception of auditors about the quality of audit and EM after the introduction of communicating KAMs in the UAE.

Data and Tools: A semi-structured interview is conducted with thirteen auditors –six Big-4 and seven Non-Big 4 audit firms.

Findings: The findings show that the introduction of KAMs enhances the quality of audit in the form of better communication and transparency, especially, in big listed firms. It increases the managerial accountability which results in minimizing the agency cost of equity. However, the study also reveals that the auditors have the audacity to confess the pressures from clients and audit firms which lead to the hidden anomalies and EM practices that resulted in decreasing the audit quality, especially in non-Big 4 firms.

Contribution: The research shows that there is no uniformity in audit practice in UAE where own nationals (Emirates) enjoy more flexibility compare to foreigners. In addition, a difference exists in the audit practices of Big-4 and Non-Big 4 auditors. The non-existence

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of stringent audit regulatory body lead to effect the overall quality of the audit. The government should implement a uniform and robust audit regulatory body to ensure the audit quality.

Keywords: Audit Quality, Earnings Management, Key Audit Matters (KAMs), United Arab Emirates (UAE), Qualitative Research, Interviews, Agency Theory.

JEL Codes: M41

1. Introduction

Agency theory of Jenson and Meckling (1986) assumes a conflict between management and majority shareholders due to information asymmetry. The managers, being an agent having more information, can exploit the asymmetric information for personal gains. The agency problem can be minimized by monitoring mechanisms of management. Auditing can be used as one form of such monitoring techniques which results in minimizing the agency cost (Iatridis, 2012). Thus, the quality of the audit is a major concern for various stakeholders. Furthermore, Barghathi *et al.* (2018) documented that audit report was sometime seen as just a legal requirement and not very useful for many stakeholders. Therefore, the regulators updates the auditing standards to ensure the usefulness and transparency of the audit report for re-establishment of the users' faith in financial statements (Wyman, 2004; Moroney *et al.*, 2021). Subsequently, in order to overcome the concerns of lack of transparency, the International Auditing and Assurance Standards Board (IAASB) initiated an extended audit report in January, 2015 in the form of International Standard on Auditing (ISA) - 701. Under this standard, the new independent audit report should contain Key Audit Matters (KAMs), effective since December 15, 2016 (IAASB, 2013). The new ISA-701 (KAMs) intends to highlight "those matters that were of most significance in the audit of the financial statement and that they were addressed in the context of the audit of the financial statements as a whole and in forming an opinion thereon, and the auditor does not provide a separate opinion on these matters" (ISA 701, par: 11).

After the inclusion of KAMs in the audit report, it is believed that management practices (such as Earnings Management, EM) are more closely observed by the various stakeholders (Gold *et al.*, 2020). Hence, it can arguably be expected that there might be greater transparency which in turn increases the quality of audits and also reduces the likelihood of EM. The EM is a very significant concern and attracts substantial attention from the corporate stakeholders. Schipper (1989) defines EM as a "…purposeful intervention in the external financial reporting process with the intent of obtaining private gain". Literature has documented that auditors might be able to uncover EM practices, however, they may not be able/willing to report about such practices as this may affect their economic benefits in the form of losing clients (Barghathi *et al.*, 2017; Barghathi *et al.*, 2018).

There have been many studies in the past few years testing the impact of KAMs on the quality of the audit and EM in the developed economies like the United States and United Kingdom (Abdullatif & Al-Rahahleh, 2020) however, very few studies exist in the context of the UAE. It is interesting to study the idiosyncratic financial market of the UAE, which is characterised by weak law enforcement, concentrated family-owned businesses, less incentives for auditors, weak regulatory framework and least accountability of audit firms (Khalifa, 2012; Odeh, 2015). Moreover, many studies on this topic uses quantitative techniques (e.g. Gutierrez *et al.*, 2018; Bedard *et al.*, 2019; Reid *et al.*, 2019) whereas, this study employs qualitative method of interview to judge the perception of auditors about the audit quality and EM in the UAE after the introduction of KAMs. We are specifically, interested to know the perception of auditors about the impact of new section in the new auditor's report (i.e., KAMs), in mitigating the EM and enhancing audit quality. We assume the introduction of KAMs in audit reports leads towards reduction in agency cost of equity as it provides more robust monitoring mechanism of management (agent).

1.2 Contextual information of auditing in the UAE

The audit regulatory framework in the UAE is governed, directly and indirectly, by a number of government organizations such as: Financial Audit Authority (FAA), State Audit Institution (SAI), Dubai Financial Services Authority (DFSA) and Abu Dhabi Accountability Authority (ADAA) (Malagila *et al.*, 2020). Auditing in the UAE can be said to have been affected by a number or factors. The country has issued some laws that have affected accounting and auditing practices. For example, The Federal Law 2 of 2015, governs companies' regulatory aspects including accounting and auditing issues. The articles 26-32 of the Law mandates the companies to prepare financial statements according to International Accounting Standards (Article 27 and 237). In addition, every company should appoint an auditor (Article 27 and 243). Article 245 of the Law requires the auditor to issue an audit report. Besides the Law, the Central Bank per se issued a Circular No 162 (2018) which required that the auditor of commercial bank should not engaged in non-audit services to the same bank.

The audit profession in the UAE is regulated by the Federal Law No. 22 of 1995, which is referred to as UAE Auditors Law (Khalifa, 2012). The Law consists of 53 articles structured in eight chapters providing general guidelines for individuals and firms to practice auditing within the country. However, the profession is largely governed and controlled by the State (Ibrahim, 2009; Khalifa, 2012). The audit firm would have to register at the Ministry of Economy (Article 3 of Law 22 of 1995). The Ministry, according to the Law, maintain a record of the practicing auditors. The

Law discusses the requirements to become an auditor in the Articles 5 and 6 of this law. The Law does also discuss auditors' rights and duties and their accountability and disciplines (see for more details, Ibrahim, 2009; Khalifa, 2012). Although the law describes how audit can be practiced in the country but it does not say about the auditing standards to be applied. However, the UAE relies on International Auditing standards (Odeh, 2015). The law allows more flexibility to own nationals (Emaraties) compare to foreigners. For example, the UAE nationals can register as an auditor with a bachelor degree in accounting with least disciplinary and ethical compliances. However, the foreigners should have professional degrees (e.g., ACCA, CPA, ACA, CPA Australia) to get registered as auditor along with five years of post-qualification experience (Khalifa, 2012; Odeh, 2015).

Besides the government organizations governing auditing and accounting in the country, a non-profit organization, The Accountants and Auditors Association (AAA), was established in 1997. The objective of the AAA is to develop the accounting profession in the country through capacity building of the national accounting profession in line with the best global practices and standards.

The AAA has signed a strategic partnership agreement with The Association of Chartered Certified Accountants (ACCA) in to order to enhance the accounting standard in the UAE. It has become mandatory, according to this strategic partnership, to complete ACCA qualification in order to obtain AAA membership which is referred to as UAE Chartered Accountant (UAECA). The new qualification (UAECA) is completely based on ACCA qualification and involves the following: completing the professional exam, gaining relevant practical experience and completing a professional ethics module. Only then one can be given the membership of UAECA. However, it is worth noting that the Ministry of Economic still holds authority to give license to conduct audit according to criteria for nationals and foreigners, where the former enjoys lots of flexibility in getting licences. The AAA is actively involved in organizing accounting and auditing seminars and workshops to promote the accounting profession (AAA, 2020).

2. Literature review

Audit is a tool demanded by stakeholders to inspect and monitor the potential threats arising from the conflict of interest (agency problem) between the owners and managers (Jensen & Meckling, 1976). The main objective of the audit is to enhance the stakeholders' trust in the financial statements of a firm and this can be ensured by appropriate level of audit quality. Various stakeholders have different perspectives about the audit quality as it is a complicated and a multi-faceted concept (Kilgore 2014). Audit quality implies how well an audit is performed (Arens *et al.*, 2017) where an auditor should be able to detect and report on material misstatements in financial statements with integrity (Knechel *et al.*, 2015).

There are two approaches to examine the quality of audit; i.e., direct approach and an indirect approach (Kilgore *et al.*, 2011). The direct approach is ex-post approach which concentrates on the outcomes of the audit process in the form of a report which contains the irregularities, if any (Barghathi *et al.*, 2018). While the indirect method considers an ex-ante perspective which uses two types of techniques to measure audit quality. Firstly, by reflecting other substitutes to establish quality like the size of the audit firm (DeAngelo, 1981; Craswell *et al.*, 1995), auditor's reputation (Craswell *et al.*, 1995), litigation practice (Palmrose, 1988), audit structure (Bowrin, 1998), non-audit services to the clients (Elstein, 2001), industry expertise (Craswell *et al.*, 1995, Hogan & Jeter, 1999) and audit duration (Geigar & Raghunandan, 2002). Secondly, the subsequent method of indirect measure implements a behavioural aspect. This method tests the quality of audit by attributing the opinions related to the different parties involved in the audit procedure and audit reports. Schroeder *et al.* (1986), Carcello *et al.* (1992), Beattie and Fearnley (1995), Warming-Rasmussen and Jensen (1998), Duff and Institute of Chartered Accountants (2004) and Barghathi *et al.* (2018) are examples of research which inculcate the behavioural studies.

This work is among the first studies which focuses on the behavioural aspect of the auditors on both audit quality and the potential usage of KAMs in reporting about EM practices in the UAE.

2.1 Key Audit Matters (KAMs)

Many studies criticised the audit report being standardised and being less informative (Gutierrez *et al.*, 2018; Pratoomsuwadn & Yolrabil, 2020). Thus, the standard setters (such as IAASB, PCAOB, UK FRC and AUASB) introduced the enhanced audit report (Mock *et al.* 2013; Vanstraelen *et al.* 2012; IAASB, 2011). The auditors are ideally required to present significant judgements in the report and must disclose audit specific information to the users of the financial statements (IAASB, 2011, 2012). The standard setters mandated the new report rules to be followed in financial statements of all listed entities. It provides information relevant to the understanding of the audit process (IAASB, 2011, 2012; Mock *et al.*, 2013). There were reforms and new introduction of sections which extended the audit report, namely; (1) KAMs disclosures; (2) it commences with the auditor's opinion which is followed in line with the 'Basis for Opinion' section; (3) revelations of going concern; (4) a dedicated section for describing the auditor's responsibilities; (5) affirmative declaration regarding the independence of the auditor along with the implementations of pertinent ethical responsibilities; (6) a short paragraph on the responsibilities of the auditors and management respectively; (7) addressed by the engagement partner (IAASB, 2015d).

IAASB initiated the implementation of the KAMs section in the new report anticipating the increase in information disclosure and communication value of the

financial statements (IAASB, 2016). Thus, the new ISA-701 –"Communicating Key Audit Matters in the Independent Auditor's Report" – was developed and implemented by the 15th of December, 2016 (IAASB, 2015). The section required the auditors to communicate the significant matters via the independent auditor's report, while judging the financial statements of the particular period and discussing the same with other governance boards (Hashim *et al.*, 2018). The process of communication of the KAMs is explained in three incrementally enhanced disclosure of key matters: (I) Matters communicated with those charge with governance, (II) Matters that required significant auditor attention in performing audit, and (III) Matters of most significance in the audit of the period. Some of the top reported KAMs in different countries are: Valuation of Property, Plant and Equipment; Impairment of Goodwill and Intangible Asset; Taxation; Management Override Control; Loan and Receivable; Provisions; Biological Asset; and Acquisition (PWC, 2017b; XRB and FMA, 2017; KPMG, 2017; PWC, 2017a; ACCA, 2018; Deloitte, 2017; SC *et al.*, 2018; and Boonyanet & Promsen, 2017).
Upon the introduction of the section, Arnold Schilder, Chairman of IAASB stated that, "this innovation in auditor reporting is radical, a step-change as some have called it. It makes auditor's work more transparent and relevant to the users. It stimulates public debate and analysis on what auditor's reports are most helpful." KAMs aims at increasing transparency by producing a detailed audit report, that in turn should reduce the level of information symmetry (Leux & Verrecchia, 2000). As the requirement of the disclosure in KAMs, additional information about potential risk in the report turns the private information to public information, thereby, reducing the information asymmetry amongst the management and stakeholders by the increased communication (Lee & Phua, 2018). We assume that the decrease in information asymmetry and increase in transparency, due to KAMs, would lead to decrease in agency cost.

2.2 KAMs and audit quality

Communicating important audit matters, due to the requirement of KAMs by IAASB, can guide different stakeholders to draw their attention towards the significant matters (Sirois *et al.*, 2018). Due to the increased attention of the users, it can be anticipated that the quality of the audit might increase due to adoption of KAMs and potentially decrease the agency cost. Scholars in different regions of the world have evaluated the implementation of the new report and its potential impact on the quality of the audit. In the UK, there has been influence on the audit quality (Gutierrez *et al.*, 2018; Lennox *et al.*, 2019; Reid *et al.*, 2019). Reid *et al.* (2019) found that the enhanced auditing report improved the financial reporting quality in the UK. However, Gutierrez *et al.* (2018) found that the enforcement of KAMs had not affected the quality of the audit. Additionally, Lennox *et al.* (2019) considered that the information provided by the auditors was not adding a value as the investors were already aware about the various risks associated with the companies. In France, since 2003, the auditors were required to produce and disclose "Justification of Assessments (JOA)" section which is quite similar to the KAMs.

Bédard *et al.* (2014) discovered that the JOAs did improve the audit quality in the first year when they were implemented. Though there was no sign of improvement in the quality in the subsequent years. Consequently, in New Zealand, it was reported that the initiation of KAMs had led to absolutely no impact on the audit quality or the audit efforts (Bradbury & Almulla, 2019). Whereas, Li *et al.* (2019) documented that improvement in audit quality were mostly associated with the audit fees, specifically for the small and non-listed firms. Similarly in Australia, it is reported that the increase in audit quality is not associated with the implementation of KAMs, whilst providing evidences that audit fees played a significant role in the efficient report (Wei *et al.*, 2018). Based on the above discussion, we hypothesize that KAMs would lead to increase the audit quality and reduce the agency costs associated with it.
H1: The introduction of KAMs increases audit quality and reduces agency cost associated with it.

2.3 KAMs and earnings management

Healy and Wahlen (1999) stated that "earnings management occurs when managers use judgement in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers" (p. 368). There are many techniques used to produce changes in the statements such as: employing different techniques in applying accounting policies, creation of provisions, writing off bad debts and classification of extraordinary items (Barghathi *et al.*, 2017).

There are mainly two approaches to EM i.e., accrual-based and real-based (Kothari *et al.*, 2005). Accrual-based EM involves manipulation based on the accounting policies and exercise judgements to influence the financial reports such as estimating future values of different economic events like the salvage value, expected lives of long-term assets, pension grants, other employment gains, bad debts values, asset impairments and deferred taxes. This can also be done while reporting the same transaction in any acceptable accounting method like the depreciation techniques – straight line method or the reducing balance method– and inventory costing method –last in first out (LIFO) or first in first out (FIFO) or weighted average method – (Healy & Wahlen, 1999; Roychowdhury, 2006). Real EM is a behaviour that sacrifices the long-term value of the firm. This technique employs ways like consideration of abnormal cash flow operation (manipulation of sales), discretionary expenses– advertising, training, research and development, and general– (Jones, 1991; Dechow *et al.*, 1995; Kasznik, 1999; Kothari *et al.*, 2005; Graham *et al.*, 2005; Roychowdhury, 2006).

The manipulation of earnings portrays two motives from the perspective of the managers. Firstly, informational perspective in which the manages signal company's prospects to the secondary market which reduces uncertainty of information resulting in stable share prices (Graham *et al.*, 2005). Secondly, an opportunistic perspective, in which a manager signals their capabilities in attaining the company's objective and would want to be benefitted by getting compensated (Watts & Zimmerman 1990; Healy & Palepu, 2001, Ghazali *et al.*, 2015).

The theory of conventional economy suggests that the managers are more prone to engage in actions that maximises their own benefits, in an unobservable situation, at the cost of others (here shareholders) expense. Severe consequences, for instance, job loss and reputational damages are of secondary concern for the managers especially in the country with weak enforcement of regulation such as the UAE (Jensen & Meckling, 1976; Kotowitz, 2008). Prior studies documented that managers exploit the flexibility in accounting choices to deliberately influence the financial statements in order to gain personal benefits, whereas the users cannot detect EM activities due to less expertise (Cassell *et al.*, 2015; Hirst & Hopkins, 1998; Lee *et al.*, 2006). Managers employ market imperfection (such as information asymmetries) technique to mislead the stakeholders about the actual firm performance, in order to earn personal benefits which reduces the level of transparency (Fields *et al.*, 2001). This act of managers enhances the agency cost.

One of the recent studies, Cassell *et al.* (2015), examined the association between accrual-based EM and the transparency disclosure requirement to the various activities of inventory allowance, bad-debt allowance, and deferred tax asset allowance. The authors found that the companies engaged less in these practices (EM), when they are ought to be transparent as per disclosure required in association with their accounts. Thus, a confirmation from an external auditor augments the transparency of firm's financial statements. An external auditor, as a gatekeeper, is answerable for validating the financial statements which are objectively analysed according to the GAAP. In order to reduce opportunistic behaviour by the management, it is anticipated that KAMs can be used by auditors to report about EM practices and leads towards decrease in agency cost. Rose *et al.* (2013) suggested that the members of the audit committee are more independent, objective and did not agree with the managerial request of managing the earnings of the firm. As it reduces the level of transparency and damages the reputation of the members of the audit committee as they are accountable to the users as well. Thus, the findings suggest that increased accountability can lead to greater transparency. KAMs proposes increased transparency. Klueber *et al.* (2018) found that KAMs led to greater transparency and managerial accountability to the users which result in a better financial reporting quality. The increase in transparency and managerial

accountability may lead to decrease agency cost. Based on the above discussion, we hypothesise that:
H2: The introduction of KAMs would decrease earnings management and agency cost associated with it.

The literature also showed that most of the studies on the topic are quantitative in nature. This research uses qualitative method of interviews to study the impact of KAMs disclosures on the quality of the audit and earnings management in the UAE market.

3. Agency theory as theoretical framework

Jensen and Meckling (1976) stated that there exists a principal-agent relationship where the agents manage the firm on behalf of the owner or the principal. Due to segregation of ownership and control, the managers may use the firms' resources for personal use which creates the agency problem. The agency cost is because of information asymmetry where the agents possess more information of the firm compare to the principals. The existence of information asymmetry may allow the managers to manipulate earnings to show a rosy picture of a firm. The mangers may indulge in the practice to secure their jobs and get more bonuses (Schipper, 1989; Warfield *et al.*, 1995). To monitor the behaviour of the managers, an external party is appointed in shape of an auditor. An auditor has a contractual relationship with the firm's stakeholder. The auditors are supposed to provide a true and fair picture of financial statements to help the stakeholders in their decision-making. However, in the recent time, auditing has created further agency relationship, which has diminished the trust and it has generated questions in relation with the independence of the auditor (ICAEW, 2005). The global demand of the auditor's role has changed and required an auditor to be independent for the key purpose of ensuring the quality of the audits (Ali & Lee, 2008). Numerous accounting scandals has led to the improvements of the function, duty and responsibility of the auditor. Prior studies found that there is a significant and positive relationship between the audit independence and quality of an audit. Gong (2009), suggests that a poor audit ''can leave the door open for irregular and illegal financial behaviours''. It is necessary that external auditing is practiced, as it enhances accountability in a professional manner and in the form of an audit report (Laffan, 2003). Therefore, it is extremely significant to establish a good quality report as the auditors are accountable for the same.

To allow auditors to have their judgements on key matters, KAMs are introduced in January 2015 in the audit report with the intention to enhance the audit quality in the UAE. Thus, the KAMs are introduced as the new mechanism to solve the agency problem by improving the audit quality, that shall benefit the users in their decision-making process (Hashim *et al.*, 2018).

Thus, the study concentrates on, whether an external auditor provides a good quality audit after the implementation of KAMs and additionally, helps in detecting and declaring EM practice with the help of the enhanced audit report. Thus, we hypothesize that the introduction of KAMs decreases the agency cost of equity.

4. Research methodology

A semi-structured interview method is used for the data collection. The motive of adopting interview method is to have an in-depth analysis of EM and audit quality after the enactment of KAMs. Proper protocols are followed in conducting the interviews from preparing interview guide till the analysis of interviews. Sample was collected using different methods like the homogenous and snowball sampling. Homogenous technique was employed as the interviewees were chosen with similar characteristics as the research only required opinions of an auditor (Dicicco-Bloom & Crabtree, 2006). Snowball sampling technique help the researcher to approach the other relevant respondents with the reference of an interviewee.

This study uses the thematic analysis technique to comprehend the data collected during the interviews. Thematic analysis identifies, analyses and reports pattern (themes) within the data (Braun & Clarke, 2006). According to Braun and Clarke (2006), there are six phases in the thematic analysis i.e., (1) Familiarizing the data collected, (2) Designing codes and categories, (3) Identifying themes, (4) Evaluating themes with the codes created, (5) Outlining and recognising themes, and (6) Analysing the data. Precisely, it’s a process of developing themes and sub-themes by cracking the textual data in manageable portions (Hollway & Jefferson, 2008).

The data collected for the research was recorded with the consent of the participants. This was done with the sole aim of reliability, as the codes were created on the information received from the interviews. The interviews are transcribed for crafting themes and sub-themes based on the similar answers and supported with relevant quotes of the interviewees.

As already mentioned that an interview guide is prepared based on thorough literature review and research objectives. Apart from the background questions, a total of 10 questions were asked during each interview. The questions were primarily categorized into three groups: (1) Views about the introduction of KAMs in new audit report and its implications; (2) Views of auditors about audit quality after KAMs; and (3) Views about EM due to introduction of KAMs. Appendix is the interview guide.

The interviews were conducted in Dubai, United Arab Emirates (UAE). The potential participants were sent an invitation via email requesting their cooperation and support for the study. The email also included an introduction of the topic along with the guidelines for conducting interviews.

A total of 18 auditors were contacted and only 13 agreed to give interviews. Out of 13, only six were interviewed face-to-face on a mutually agreed time. The remaining seven interviews were conducted via electronic media such as such as Google Meet and Zoom due to remote location or busy schedule. All the interviews were conducted in the Months ranging from December 2018 to Mar 2019. On an average, each interview lasted for about an hour. Table 1 summarises the background information of respondents. Six interviewees were working in Big-Four audit firms while seven participants belong to non-big four audit firms.

Table 1. Participant Information

BIG FOUR PARTICIPANTS					
Respondents	**Gender**	**Medium**	**Job Position**	**Qualification**	**Experience**
BF1	Female	Interview	Audit Associate	ACCA	Less than 5 years
BF2	Male	Forms	Senior Associate	ICAP Affiliate	5 to 10 years
BF3	Female	Forms	Audit Associate	ICAEW Affiliate	Less than 5 years
BF4	Female	Telephone	Senior Associate	ACCA	5 to 10 year
BF5	Female	Telephone	Audit Associate	ACCA Affiliate	Less than 5 years
BF6	Male	Forms	Senior Auditor	ACCA	Over 10 years
NON-BIG FOUR PARTICIPANTS					
Respondents	**Gender**	**Medium**	**Job Position**	**Qualification**	**Experience**
NBF1	Female	Interview	Senior Auditor	ICAI	5 to 10 year
NBF2	Male	Interview	Senior Auditor	ACCA	5 to 10 year
NBF3	Female	Email	Senior Auditor	ACCA	5 to 10 year
NBF4	Male	Interview	Senior Associate	ACCA	Less than 5 years
NBF5	Male	Interview	Audit Manager	ICAI	5 to 10 years
NBF6	Male	Forms	Senior	ACCA	5 to 10 years
NBF7	Male	Forms	Partner	ACA	Over 10 years

5. Analysis of interviews

The analysis of interview is carried on the basis of two broad themes; i.e., Audit Quality and Earnings Management, after the enactment of KAMs.

5.1 KAMs and audit quality

This section focuses on various factors, commonly expressed by the interviewees, which affect the audit quality. The Appendix shows the questions related to KAMs and Audit Quality. The analysis of the responses of the questions enables us to divide the theme into sub-themes. The theme 'Audit Quality' is further categorized into five sub-themes i.e., Material Misstatement, Objectivity, Standard Compliance, Transparency and Communication, and Future Challenges.

5.1.1 Material misstatements

Initially, the participants were asked to define audit quality according to their own understanding to get their perception about the matter. The interviewees identified material misstatements as one of the concerns, hindering the quality of an audit. For example, NBF4 commented:

> *"I think, audit quality is about presenting a report which is free from material misstatements and the auditor must be aware of the assessed risks so that he/she can put the finest report. Umm.., it also requires the report to be independently reviewed and certified by a qualified auditor, so it becomes quite reliable for the different stakeholders."*

NBF1 expressed that:

> "*The audit quality mainly depends on the materiality of the financial statements and detection of any material misstatements is the responsibility of an auditor."*

The participants who referred material misstatements as a concern, were further enquired about the changes occurred (if any) pertaining to material misstatements after the commencement of the KAMs section in audit report in the context of the UAE. Mostly, interviewees affirmed the positive impact where the stakeholders consider KAMs as a tool which highlights the high risks associated to material misstatements. The views of auditor NBF4 on it is:

> *"Before KAMs, I do not have any experience to engage in reporting such things, nor have I seen any of my colleagues doing so. But after introduction of KAMs, we have more clues about what is going on and become more aware with risky areas identified in KAMs."*

BF5 testified that:

> *"Definitely, there has been a positive impact because we are more attentive towards key matters which can be a potential threat. This has indirectly improved the quality of the audits."*

It refers that KAMs reports material misstatements that leads to increase in audit quality and it may result in reduction of agency cost.

5.1.2 Objectivity and unbiased opinion

In the extension to the previous question, the auditors also had strong views that the quality of audit depended upon the independence of an auditor (DeAngelo, 1981; Tepalagul & Lin, 2014) and believed that a true and fair report is equally significant. In this regard, BF1 narrated that audit quality is "basically about the auditors carrying out the audit objectively and provide a true and fair view." The auditor BF3 further elaborated:

> *"A consistency in audit is a key for a quality audit. In addition, it should be in line with the requirements and professional standards, within a strong system of quality controls. And all these related activities should be undertaken in an environment of the utmost level of objectivity."*

Similarly, the respondent NBF5 added that:

> *"Audit quality would be achieved through an environment of audit awareness, support and appropriate interactions amongst the supply chain participants of the financial statements through deployment of knowledgeable and skilled resources to enable a true and unbiased review of financial position and performance of the companies."*

Subsequently, they were asked about the independence of auditors, primarily in Dubai, after the introduction of the enhanced audit report. There were conflicting views among the auditors. Half of them advocated that the independence of an auditor is the most significant factor and must be enacted. Whereas, the other half agreed and confessed that independence is a pre-requisite but often compromised due to factors like client importance and non-audit services. In this regard, the auditor BF4 documented:

> *"I feel that objectivity is very essential while conducting an audit. I don't think KAMs has changed anything really, as audits were, is and will be performed independently by auditors."*

However, the interviewee from non-Big four NBF5 endorsed that:

> *"I think independence is not an issue until those clients are our clients in other non-audit services too, because we don't want to lose them. But we do give a heads up to them if such an issue arises."*

These contradictory responses from both the participants is also documented by Chi *et al.* (2012) while comparing the Big Four and Non-Big Four firms, where the Big Four firms do not compromise on the audit independence while the Non-Big Four firms are more likely to do so. It portrays that there is a negative correlation amongst the client importance and audit independence (Trompeter, 1994; Carcello & Hermanson, 2000; Wright & Wright, 1997; Krishnan & Krishnan, 1996). Additionally, engagement of audit firms for non-audit services can also lead to compromise in auditor's independence (Chen *et al.*, 2005; Gul *et al.*, 2007; Thornton & Shaub, 2013). Because of this issue, the Central Bank of the UEA issued a circular to ban auditors to provide non-audit services to the audited companies (Circular No. 162 in 2018)

5.1.3 Standard compliance

All participants were of the opinion that compliance of audit standard is the prerequisite for a quality audit as per se (Chadegani, 2011). For example, the interviewee NBF3 believed that “Audit quality is based on compliance with the standards along with complementary factors such as auditor’s knowledge, skills, experience, and scepticism.”

However, when the participants were asked about the ground realities of fulfilment of these standards in the UAE, many of the auditors mentioned the issue of non-compliance. They identified that reasonable measures were not taken in the UAE to monitor the audit process which in turn affects the quality vis-à-vis other countries. For example, the auditor BF4 stated that “The compliance is not up to the level compare to other countries who have a legal obligation to get audited under the observance of set standards.” In line with this, the Interviewee BF2 believed that “the lack of governing bodies, which give a room of flexibility for audits, is specific to the UAE, which hampers the quality.”

In continuation of the above narrative, the respondent NBF2 gave more detail about this argument:

> *“If you look at the UAE and compare it with different countries, the later doesn’t have many rules for audit except for a few companies registered in the Free-zones have strict audit compliance. There are many firms where the auditors are the ones preparing the financial statements and do the audit as well. This is not the case in other countries, it is the management’s responsibility to prepare the statements and the auditors are supposed to review it and give an opinion only.”*

Here the ambiguous role of auditors, who are also involved in preparing the financial statement, would seriously influence the overall financial reporting in the UAE. It would also lead to increase the agency cost as the auditor is also the accountant of financial statements.

Some participants did not consider any significant improvement in compliance after the application of KAMs. However, the introduction of Value Added Tax (VAT) has apparently compel auditors to pay more attention to the importance of compliance with the rules and regulations. The rationale is that now government would be interested in fair audited reports to levy VAT and it may lead to increase the audit quality. However, a recent study by Sadderudein and Barghathi (2018) documented that VAT although will not affect the audit quality, instead, it is an additional area of work which will increase the auditors’ responsibilities. In line with this, one participant considers the improvement in compliance after the establishment of VAT. The auditor NBF5 documented:

> *"The level of awareness regarding audit and compliance in the UAE was not at par with its International counterparts in the Pre-VAT era. However, with the introduction of compliance regulations through various decrees by the Ministry in recent times, the UAE can witness an improvement in audit as per international practices."*

In addition, the Interviewee NBF5 suggested that "there is a greater need for compliance checks through peer reviews to ensure compliance of the recommended practices or standards."

The lack of compliance and ambiguous role of auditor as accountant lead to affect the audit quality and increase agency cost. There is a need to have a strong auditing regulatory body in the UAE to have uniform treatments for both national and foreigners audit firms.

5.1.4 Transparency and communication

The participants favoured the views that the introduction of KAMs enhanced the transparency and communication of an audit which is a fundamental feature of a quality report. For example BF2 elaborated that:

> *"The new report now gives more detail and clarity on the audit opinion. It makes the report transparent as well, since an explanation is now provided over the opinion given."*

The respondent BF1 endorsed the views and highlighted the important of KAMs in the new audit reports:

> *"It definitely improves the transparency as it communicates essential information that is specific to the entity, umm…I like the valuation of PPE, impairment of intangible assets etc."*

The valuation of Property, Plant and Equipment (PPE) and impairment of Intangible assets are among the top five important KAMs identified in new audit report in different counties such as the UK (Reid *et al.*, 2015); France (Bédard *et al.*, 2014); New Zealand (Li *et al.*, 2018); Thailand (Boonyanet and Promsen, 2017) and ACCA (2018) study in Brazil, Cyprus, Kenya, Nigeria, Oman, Romania, South Africa, the UAE and Zimbabwe.

This response is in agreement with the study of Klueber *et al.* (2018) which documented that greater transparency could be expected through KAMs as a result of increased in the managerial accountability. The concept of managerial accountability, through new audit report, can be a useful tool to monitor managers and reduce the agency cost. It refers that the introduction of KAMs is beneficial in minimizing the agency cost of equity and restore the confidence of shareholders in the fate of a firm. The Interviewee BF3 emphasised that:

"It [KAMs] is very useful and also increases the shareholders confidence in the company."

5.1.5 Further challenges

Although the introduction of KAMs is instrumental in minimizing many issues that lowered the quality of an audit, but it faces a few challenges in the UAE market. The challenges are mainly raised by the Non-Big Four auditors who shared the experience of Small and Medium Enterprises (SMEs) where the KAMs did not bring much improvement in audit quality (Odeh, 2015). For example, the Interviewee NBF3 elucidates this through her own experience as such:

"I don't think that it [KAMs] has much impact on the audit quality in terms of my portfolio and clients. However, for larger corporations there is an increase in transparency such as, if there is a company which is listed in the UAE, this [KAMs] helps us bring issues into the surface which may have material implications, if not rectified now."

Additionally, the Non-Big Four auditors also express their dilemma with regard to the application of KAMs produced by audit reports in the SMEs. Thy auditors feel that the KAMs is too generalised and very monotonous which are not very helpful to users. The auditor NBF1 mentioned that:

"It [KAMs] is supposed to provide more clarity, but for SMEs here in the UAE, it is a kind of redundant practice and we copy-paste the same things year by year. Most of them are much generalised and, as an auditor, we don't take much efforts as no one really bothers about these points. But for the larger corporations, they take sufficient time to build that and specify the main things in an audit report."

The views are in line with the work of Odeh, 2015 who worked on the audit quality in the UAE.

5.2 Earnings management

The segment analyses the ways EM reduces audit quality, followed by the potential reasons that obstruct an auditor from reporting EM in a (revised) audit report. Finally, how the implementation of KAMs has led to changes in the practice of EM. Whether KAMs can be used to report on EM or not, interviewees have expressed mixed views. Majority auditors believed that, when auditor uses his/her professional judgment, this requires reporting EM under KAMs. The Interviewee BF6 stated:

"Yes, it provides more opportunity to report on EM. Of course, what to be reported under KAMs is a professional judgment and KAMs captures the attention of readers to the matters significantly important while making professional judgment".

On the other hand, some interviewees had a different view. For example, Interviewee NBF6, who viewed EM as a potential way of committing fraud, believed that EM could be reported in an audit report with or without KAMs. He provided the following statement:

> *"EM is a matter of fraud and should be dealt with accordingly. It is unlikely a matter that would be reported as part of KAMs".*

After asking the interviewees about the existence of EM in the UAE and it's reporting in KAMs, the subsequent questions were about its relationship with audit quality in the context of the KAMs. Various sub-themes were extracted from the analysis of the interviews i.e., Audit Quality, Guidelines of KAMs, Pressure from Clients, Pressure from Audit Firm, and Amendments.

5.2.1 Impact on audit quality

When the participants were questioned about their views on the relationship of audit quality and EM, all participants believed that EM negatively affects the audit quality. This opinion is also in line with the studies performed by various researchers Gerayali *et al.*, 2011; Srinidhi and Gul, 2007; (Barghathi *et al.*, 2017; Barghathi *et al.*, 2018;). For example, the participant BF2 documented:

> *"Yes, it definitely affects the quality. When EM is used, it has a negative impact on the quality of audit. In EM, the companies use accounting policies that generate higher short-term earnings and try to show a rosy image of the firm, which is definitely not true and fair."*

An auditor from Non-Big Four, NBF5, expressed similar opinion:

> *"Yes. An auditor is seen as an outsider who presents an unbiased opinion on the financial well-being of the companies which empowers stakeholders in timely decision making. Earnings management defeats the whole purpose of the audit"*

The existence of EM not only deteriorates the audit quality but equally enhances the agency cost where management manipulate earnings for personal gains.

5.2.2 Guidelines of KAMs and EM

From the previous section, it is obvious that EM negatively affects the audit quality. However, a few participants agreed that the audit quality can be improved due to the reduction in the EM as a result of KAMs. All the participants believed that there were no detailed new guidelines that brought all key matters to the attention of the users. The findings are in agreement with the negative association of KAMs on the EM practice (Velte & Issa, 2019).

Among the few respondents who were in favour of KAMs and EM, the respondent BF3 stated that:

> *"KAMs sets out clear guidelines which help auditors in following specific path in terms of taking timely actions to report an earnings management."*

In similar line, the Interviewee BF4 documented:

> *"The KAMs did increase our attention towards the issues like earnings management and its reporting in the audit reports. This in turn increases the confidence of the users in the audit and the financial statements, which is in the public interest."*

5.2.3 Pressure from the clients

In continuation to the question asked pertaining to the influence of KAMs over EM, it was narrated by few participants that KAMs did not reduce the EM. The reason is a pressure from the clients (management) to portray a rosy picture of their firms. It refers that management is indulged in EM to secure their jobs and so false representation of financial statements for different stakeholders. This situation not only shows the inefficiency (dishonesty) on the part of auditors but also leads towards the increase in agency cost. The interviewees refute their involvement in such practices, but confessed and had the audacity to accept the existence of such practices in overall audit industry in the UAE. In the regard, the Auditor NBF1 was very forthright in her response:

> *"We are told by few clients to show good numbers in the report for various reasons, such as, the firm is going to be sold in near future, or to build reputation in the eyes of shareholders, and they want the same to show a rosy picture."*

One of the auditors gave a recent example of a client who requested for this practice. The respondent NBF2 narrated:

> *"A month back, I was doing audit of a client, who had a request of manipulation in sales and cost of goods sold to show fancy books as the firm was in the process of being acquired. However, we did not encourage this practice."*

Similarly, the Interviewee NBF3 commented:

> *"After KAM we definitely did pay more attention towards EM, and identified these practices too. But most of our clients explicitly ask us not to do so for reasons and that's why I don't think introducing KAMs has really helped in reducing these practices."*

5.2.4 Pressure from audit firm

In addition to the pressure from the clients to hide anomalies and not to report in KAMs, the auditors also face pressure from their own audit firm (an indirect pressure from clients). Few participants revealed that they confront such pressures from their own managers (audit firm). The audit firms do these things because of the fear of losing the clients. Moreover, a cut throat competition in the UEA market and ineffective regulatory bodies gives a room to the clients to switch over to another audit firm. Thus, an auditor cannot afford to lose a single client and they may pressure the auditors not to show the anomalies in the form of KAMs. The respondent NBF2 stated that:

> *"We have double pressure from both client and own audit firm. The temptation to keep the clients intact and the preservation of commercial aspect of audit firm lead to compromise on audit quality and we have to do signature on audited reports."*

NBF3 expressed her own experience with a client who demanded a manipulation in the figures.

> *"Out of the 40-50 clients audited, only in one instance the earnings management was reported. However, we lost the client and worse, keeping in line the commercial aspect of assignments, the management no longer allows us [Auditors] to do so."*

However, the concern of losing their clients was high amongst the auditors from Non-Big Four audit firms. Whereas, the interviewees from the Big Four firms did not face any such pressures. For example, the respondent BF1 stated:

> *"Earnings management is an issue in the UAE, but only 1 or 2 clients asked us to make changes in the revenue figure to show a wrong picture of the firm. But this was not entertained by our management and was rejected, however, we lost the client."*

Contrary to that, a participant NBF1 made an assertion that there has to be uniformity amongst the auditors in the UAE and this can be achieved with more stringent rules from regulatory bodies. Until, there is no robust regulatory framework for all audit firms, only KAMs cannot be influential in reducing EM and increasing the quality of the audit. In this regard NBF1 stressed that:

> *"KAM wouldn't simply work especially in the UAE, to reduce EM, because of all the pressures we face from our own audit firm. However, more stringent regulatory rules could actually work in the reduction of this practice."*

It refers that pressures from clients and audit firm lead to under-reporting of EM resulting in low audit quality especially in non-Big four firms. It also increases the agency cost as managers influence the auditors – the gatekeeper.

6. Conclusion and way forward

In the field of auditing, there has been various factors hindering the quality of an audit report. Specifically, in the UAE market, along with the factors mentioned in the literature section, there were a few significant challenges identified during the interviews with the auditors in the Big Four and Non-Big Four audit firms in the context of KAMs. We assume that KAMs would decrease the agency cost of equity. It provides the monitoring mechanism of managers with more robust audit quality reports in the forms of judgements of auditors in KAMs.

Firstly, all the auditors believed that the material misstatement was a significant factor in assessing the audit quality and the introduction of KAMs has led to the examination and reduction of material misstatement. When the participants were asked about their views on auditor independence in the process of audit, It was identified that the Non-Big Four participants had lesser independence compare to Big Four firm in shape of client undue demands and fear of losing clients etc. These factors may restrict the auditors of Non-Big Four firms in giving their judgements in the form of various KAMs. While, the opinions from the Non-Big Four were not favourable regarding the implementation of KAMs, the auditors of Big Four favoured KAMs for the auditor's objectivity.

Secondly, the next factor in the audit quality is compliance with standards. It was noted that the compliance was not an issue in the UAE, but the participants raised another unanticipated issue regarding the standards. The audit standards in the UAE are less stringent and provide flexibility in execution. The standards are not uniform and depends on the auditors (and the audit firm) to follow them independently or not. This result comes in line with Barghathi *et al.* (2020) who concluded that audit quality in the UAE is relatively low compared to other jurisdictions due to, among other things, lack of monitoring by the government. However, there was a pattern observed that despite the flexibility aspect, the auditors of Big Four did not consider it as a big issue as they performed their audits in conformity with the established standards. However, the respondents mentioned that the standards are not up to the mark compared to other countries. Nonetheless, in the Non-Big Four firms, few standards that were implemented due to the VAT, fairly improved the audit practice in the UAE.

Thirdly, the transparency and communication levels were asked after the introduction of KAMs. All Big Four participants believed that it is a great initiative to portray all the key matters to the users of large listed firms. In contrast, the auditors of Non-Big Four believed that not many people go through the audit report and the KAMs worked for large firms only not for SMEs.

Lastly, it was also noted that the EM plays a great role in hampering the audit quality. Thus, the interviewees were enquired about impact of the KAMs on the reporting pattern of the EM practice in the UAE. Similar to the impact on the audit quality, there were contradicting views from the auditors working in the Big Four and Non-Big Four firms. As the interviewees from the Big Four firms believed that the KAMs helped in the reduction of the EM practice in the UAE and did not encourage any request from the clients on hiding the practice of EM. Whereas, the auditors of the Non-Big Four firms raised other issues like pressure from the clients and their own management for hiding the practice of EM as they fear the loss of a client. Therefore, detecting EM is possible but reporting them is another story and often compromised at the behest of clients. Consequently, the existence of only KAMs cannot be enough to reduce the practices of the EM until there are more stringent rules from regulatory bodies that can bring uniformity in the audit practices.

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Appendix

Interview Questions List

<table>
<tr><td colspan="2">Section A: Background Questions</td></tr>
<tr><td colspan="2">Job position: _____________</td></tr>
<tr><td colspan="2">What is your place of work?
a) Big Four
b) Non-big Four</td></tr>
<tr><td colspan="2">Are you professionally qualified: Yes or no. If yes, which one:
a) ICAI
b) ACCA
c) ICAEW-ACA
d) ICAP
e) Other: __________</td></tr>
<tr><td colspan="2">Mention the work experience in the field of auditing?
a) Less than five years
b) Five to ten years
c) More than ten years</td></tr>
<tr><td colspan="2">Section B: Impact of KAM on earnings management and audit quality</td></tr>
<tr><td rowspan="3">New Section</td><td>Did you find any prominent issues with the previous structure of the audit report?</td></tr>
<tr><td>What is your take on the new section of the audit report, KAM? And do you think this adds value to the new audit report?</td></tr>
<tr><td>How do you worth the new report in terms of communication and transparency?</td></tr>
<tr><td rowspan="3">Audit Quality</td><td>How do you define audit quality, in your own words?</td></tr>
<tr><td>In your opinion, how do you perceive audit quality in the UAE?</td></tr>
<tr><td>What influence does the KAM section have on the audit quality of an audit report?</td></tr>
<tr><td rowspan="4">Earnings management</td><td>Do you think EM is a significant issue in the UAE?</td></tr>
<tr><td>How does EM affect the quality of the report?</td></tr>
<tr><td>Till what extend do you think that introduction of KAM would provide you with more opportunity to report on EM?</td></tr>
<tr><td>Have you reported EM while analysing the KAM of a firm? If yes, how did you use KAM to report on EM?</td></tr>
</table>