

**“BABEȘ-BOLYAI” University**

**Faculty of Economics and Business Administration**

**Doctoral School of Economics and Business Administration**

**DOCTORAL THESIS**

**ELEVATING AUDIT TRANSPARENCY: A  
COMPREHENSIVE EXAMINATION OF  
KEY AUDIT MATTERS IN TODAY'S  
FINANCIAL AUDITING LANDSCAPE**

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## **SUMMARY OF THE DOCTORAL THESIS**

### **ELEVATING AUDIT TRANSPARENCY: A COMPREHENSIVE EXAMINATION OF KEY AUDIT MATTERS IN TODAY'S FINANCIAL AUDITING LANDSCAPE**

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In the context of a continuously evolving economy, transparent communication among stakeholders has become crucial. The global financial crisis of 2007 exposed deficiencies in financial reporting and auditing, leading to concerns from investors and regulators. Stakeholders, including investors and regulatory authorities, began expressing mounting concerns and emphasized the need for auditors to provide more pertinent and informative audit reports, especially concerning areas within financial statements that necessitate substantial judgment. In response, the International Auditing and Assurance Standards Board (IAASB) introduced ISA 701, "Communicating Key Audit Matters in the Independent Auditor's Report". This aimed to address the limitations of traditional audit reports in conveying the audit process and auditor judgments. ISA 701 was seen as a way to provide specific company information and bridge the gap between auditors and stakeholders. However, concerns soon arose in the literature about ISA 701's formal language and structure, which some argued limited its effectiveness. There were also worries about standardized language diluting the standard's original intent. While the goals set by ISA were praiseworthy, its reception highlights the complex journey from intention to achieving a uniform and broadly applicable implementation.

This PhD thesis is primarily focused on the communication of Key Audit Matters and is organized into a coherent structure. It commences with a structured literature review that serves multiple purposes, aiming to provide a broad understanding of the topic. Subsequently, based on the identified gaps in the existing literature, the thesis proceeds to its second and third chapters, which consist of two empirical studies. The first study is centered on the European context, while the second one specifically addresses the situation in Romania. This sequential approach allows the thesis to transition from a general exploration to a more specific and in-depth examination of the subject matter.

*In its first chapter*, this study conducts a structured review of the existing literature on Key Audit Matters. It specifically focuses on two categories of factors: measurable and non-measurable, which influence the disclosure of KAM. Additionally, the study investigates the additional value that KAM bring to stakeholders. To achieve this, the research employs a structured literature review methodology, following the framework established by Massaro, Dumay, and Guthrie in 2016. Structured literature reviews adhere to a set of well-defined rules and it is suitable for this study it guides the researcher towards obtaining clear responses to the research questions. This study examines 73 selected papers out of 160 identified through a comprehensive inquiry process. These papers were sourced from the Web of Science database, without imposing a specific time restriction, considering the novelty of the topic, up to the research date in 2023.

Among the measurable factors, various variables have emerged as significant. Notably, the gender of the auditor or audit partner, the industry of the audited company, the presence of significant accounting estimates accompanied by uncertainty, the location of the audited company, the type of auditing firm, audit fees, the level of market regulation, and the presence of an audit committee have been identified as influential factors.

Our analysis of the literature indicates that female audit partners tend to provide more comprehensive KAM disclosures. Regarding industry, studies have revealed that some industries pose greater auditing challenges than others, leading to variations observed both within and between industries. Companies in heavily regulated sectors, particularly the financial industry, tend to disclose a greater number of KAM. Additionally, companies with extensive subsidiary networks, especially within the technology, real estate, construction, and finance sectors, tend to have more KAM disclosures. A noteworthy trend among auditors is their inclination to prioritize industry-specific matters over entity-specific ones. This preference is driven by auditors' concerns about maintaining client relationships and safeguarding their audit firm's reputation, which, in turn, reduces their exposure and potential litigation risk.

Geographical location plays a significant role in KAM disclosure, with some European countries, particularly from more developed regions, placing greater emphasis on communicating KAM compared to others in less developed areas where the KAM section may be omitted from the auditor's report. Although ISA 701 doesn't impose a specific minimum requirement for KAM disclosures, it generally expects at least one KAM to be disclosed.

Differences between Big 4 and non-Big 4 audit firms were identified, mainly due to varying perspectives on the nature and importance of Key Audit Matters. Big 4 firms tend to disclose more KAM and exhibit diverse approaches. There's a notable lack of uniformity among audit firms in the audit procedures they employ for similar matters. Big 4 firms often adopt a more standardized approach, primarily to mitigate auditor liability. Auditors affiliated with larger firms tend to provide more specific disclosures to safeguard their company's reputation. When examining Big Four firms individually, differences in their KAM reporting emerge. Deloitte and EY auditors focus more on numerical information compared to PwC. Additionally, Deloitte, EY, and KPMG disclose fewer Key Audit Matters related to entity-level risks compared to PwC. On the other hand, KPMG and BDO often report fewer Key Audit Matters associated with account-level risks in comparison to PwC. Each Big 4 audit company may also follow slightly different internal guidelines for KAM reporting.

In terms of audit fees, multiple studies have observed a positive correlation between audit fees and the number of KAM disclosures. This relationship is complex and influenced by factors such as the size and complexity of the audited company, among others. Notably, during the COVID-19 pandemic, audit fees increased alongside more detailed Key Audit Matters disclosure. Regarding audit committees, several studies have highlighted their close connection to KAM communication. For instance, KAM readability is positively linked to female representation on the audit committee and their financial and industry expertise. However, having female members on the audit committee tends to result in fewer and shorter KAM disclosures by auditors. Nevertheless, these committees with female members tend to provide more specific information, identify more firm-specific KAM, and produce KAM that are generally easier to understand. Audit committee membership overlap also has a positive influence on KAM disclosure due to knowledge sharing when individuals serve on multiple committees simultaneously. However, in cases where audit committee members possess both accounting and industry expertise, there was observed a reduction in the overall number of KAM disclosures.

Shifting to non-measurable factors that influence KAM disclosure, the study underscored the significance of the uncertainty level regarding ISA 701's comprehension, complexity inherent in accounting treatment, and auditor litigation risk. ISA 701 adopts a principle-based approach, granting auditors substantial discretion and judgment in determining both the quantity and substance of Key Audit Matters. However, by doing so, it leaves a lot of room for

interpretations, therefore, as also identified when assessing the impact of the audit company, different auditors might have different views based on their understanding of what is required to be communicated as a KAM, fact resulting also in different practices among audit firms. Based on their judgement, some auditors tend to focus more on industry-specific matters over entity-specific or accounting ones, or often designate risks related to revenue recognition as significant and communicate them as KAM. Similar decision is also made by auditors again based on their judgement if to communicate issues related to going concern also as KAM, even if ISA 701 dictates that these matters should be documented following ISA 570 (Revised) rather than being explicitly mentioned in the KAM section of the auditor's report. Regarding the complexity of the accounting treatment, measurement uncertainty featured prominently, influencing auditors' decisions in reporting KAM related to accounting estimates and asset impairment. Furthermore, auditors exhibited a propensity to disclose more KAM when faced with uncertainties related to accounting treatments, such as significant transactions, revaluations, and accounting estimates, as part of a risk mitigation strategy. The predominant Key Audit Matters, in a general context, revolve around accounting standards governing inventories, property, plant, and equipment, asset impairment, investment property, business combinations, impairments of goodwill and revenue recognition. These areas consistently give rise to intricate accounting treatment, making them the focal points of KAM communication. Also, the choice of auditors tend to lean towards communicating Key Audit Matters related to entity-level risks over accounting-level risks or opt for industry-generic KAM, is often driven by a desire to mitigate risks, evade regulatory scrutiny, and navigate the pressures and potential misunderstandings stemming from audit committees. Under this consideration, it was noted that ISA 701 may increase litigation risk because it provides stakeholders with more detailed information about areas of judgment and complexity in the audit. If issues or problems arise in these areas, stakeholders may scrutinize the auditor's communication of KAM and potentially hold them accountable for any discrepancies or failures in the audit process.

With respect to stakeholders, the opinions in the literature are contradictory. On one hand, some studies highlight that KAM disclosure may widen the expectation gap, potentially causing risk-averse investors to misconstrue audit report information and rethink their investment decisions. Furthermore, it's essential for auditors to pay attention to the terminology employed when conveying Key Audit Matters, as there exists a correlation between the readability level and the overall informativeness of the audit report.



Noteworthy findings from this SLR indicate that the implementation of ISA 701 has a positive impact on the auditing profession. It can mitigate auditor liability and bolster investors' perception of the reliability of reported information, by increasing transparency, improving communication, documenting professional judgment, reducing the expectation gap, and enhancing audit quality. Furthermore, KAM disclosure enhances financial reporting quality, augments the value of the audit report, and indirectly piques interest in it. The expectation gap between auditors and users of audit reports and financial statements appears to have contracted according to some studies.

However, other studies highlighted that ISA 701 seems to have fallen short of its initial intent, as KAM disclosures lack the desired specificity to elevate audit report quality, as originally envisaged.

Based on these results, the further chapters are focused on the literature gaps identified that are the following:

- i. the limited attention to multiple European countries from various regions studied together;
- ii. the current predominant focus on developed nations, like the early adopter, the UK, offering very limited attention to emerging economies countries;
- iii. no clear consensus obtained in the literature regarding whether ISA 701 has effectively improved the quality of audit reports and implicitly if the informative value of the report increased since the standard's adoption;

The first gap is addressed to the empirical study conducted in the second chapter of this PhD thesis, while the last two literature gaps are being addressed through the last chapter.

In terms of contributions, this research enhances stakeholders' understanding of KAM by explaining the underlying factors that influence the disclosed matters, enabling more informed decision-making. Moreover, it offers valuable insights for auditors regarding the repercussions of disclosed matters on stakeholders. Furthermore, it identifies the current responses of audit report users, which can be instrumental in refining how these matters are communicated in the future. These findings may improve audit report quality and narrow the expectation gap. Also, the study synthesizes diverse perspectives on the added value of Key Audit Matters for stakeholders. It evaluates the advantages of the revised audit report format in accordance with ISA 701. These findings serve as valuable input for standard setters, aiding their

comprehension of current market responses and guiding potential enhancements to the standard's requirements. The researcher's contributions in this study are novel in that they have consolidated findings on Key Audit Matters across a wide spectrum. This study is unique in its comprehensive synthesis of KAM-related information, offering a clear and overarching perspective on ISA 701 while also identifying gaps in the existing literature.

*In the second chapter*, starting from the above mentioned literature gap, this study explores the variables affecting the frequency of Key Audit Matters mentioned in audit reports, a crucial indicator of financial statement complexity and risk. ISA 701 adopts a principle-based approach, granting auditors substantial discretion and judgment in determining both the quantity and substance of Key Audit Matters. A higher number of KAM signifies greater judgment and potential risks. Furthermore, the significance of this study is validated when considering that the quantity of Key Audit Matters indirectly affects the capital market influencing the investors' decisions.

Based on the literature, we have selected six measurable factors which refer to the characteristics of the entities being audited as well as those of the auditor that are considered to impact the number of communicated KAM, namely: industry of the audited company, European Region of the audited entity, audit fee, auditor type (Big 4/non-Big4), auditor's opinion type and going concern risk. Hence, the number of KAM was defined as the dependent quantitative variable, whereas the listed above factors were used as independent variables. Also, the model also included two control variables: revenue and market capitalization. Given the study's comprehensive assessment spanning multiple aspects over a period exceeding one year, a panel regression model is suggested for validation. This model utilizes the Ordinary Least Squares (OLS) method to examine the six hypotheses proposed by the study, each assessing the impact of the mentioned factors on the quantity of Key Audit Matters. The initial study's sample was composed of 1,694 listed European entities available on the Audit Analytics database, however, after applying the relevant selection criteria the number of considered companies was reduced to 1,663. The study proposes an analysis of the KAM disclosed over a period of four years, from 2017 to 2020 as ISA 701 pertains to the audit of financial statements for publicly traded firms for reporting periods concluding on or after December 15, 2016. The decision to exclude the first year, specifically the audit opinions for year-end 2016, was made to reduce variability in the study. By omitting 2016, the study

concentrates on a period when auditors had greater exposure to and familiarity with the new standard.

Our findings indicate that five out of the six hypotheses proposed in our study have been confirmed. Regarding H1 (accepted hypothesis), which examines the influence of industry, our results demonstrate that auditors disclose a greater number of Key Audit Matters for companies operating within the Finance and Insurance sector. This outcome can be rationalized by the industry's intricate nature and the higher level of regulatory scrutiny it faces compared to other sectors. Additionally, companies in the banking sector are perceived as having greater risk, which provides auditors with a rationale for disclosing more Key Audit Matters as a precautionary measure to reduce liability and safeguard their reputation.

Regarding H2 (accepted hypothesis), which examined the impact of European regions on the number of Key Audit Matters, our findings reveal that the highest number of Key Audit Matters disclosed in audit reports comes from audit firms based in Western Europe, which is considered an economically developed region. This is partially attributed to the fact that approximately 74% of the Key Audit Matters disclosed for entities operating in the Finance and Insurance sector originate from this region. Furthermore, a significant majority of the communicated Key Audit Matters in our study are associated with audit opinions of entities from the UK. It's worth noting that the Financial Reporting Council (FRC) in the UK introduced KAM reporting earlier than in the rest of the Europe, in June 2013. This observation suggests that auditors' decisions regarding Key Audit Matter disclosure may be influenced by cultural and institutional factors.

Moving on to H3 (accepted hypothesis), our results indicate that it indeed has an impact on the number of Key Audit Matters communicated. This can be rationalized by the correlation between audit fees and heightened client risk. In complex business scenarios, auditors are often required to conduct more extensive work, and audit procedures may necessitate a greater degree of judgment.

Regarding H4 (accepted hypothesis), our findings reveal that the type of auditor plays a significant role in the quantity of Key Audit Matters disclosed, with Big 4 firms presenting a higher number of KAM in their audit reports. Furthermore, within the Big 4 group, it is noteworthy that PwC stands out by reporting the most KAM in their audit documents. These outcomes can be explained by several factors: Big 4 firms exhibit a stronger commitment to KAM disclosure compared to non-Big 4 firms, possibly driven by additional pressure from

their international parent organizations. They are also more dedicated to preserving their reputation, possess greater resources for training and knowledge acquisition in this area, and conduct frequent internal quality assessments.

The study's fifth hypothesis investigating the impact of type of audit opinion the number of KAM was rejected, result mainly explained by our sample structure that contains an average of 0.2% of qualified opinions.

Finally, regarding H6 (accepted hypothesis), our results showed that statistically significant correlation between going concern issues and the number of KAM. This connection arises because, in practice, certain auditors opt to communicate going concern issues as part of their KAM disclosures, despite ISA 701 primarily addressing KAM and leaving the treatment of going concern issues to ISA 570 (Revised).

In terms of contributions and future benefits, this research addresses a gap in the existing literature and enhances stakeholders' comprehension of Key Audit Matters in financial reporting. It highlights commonly identified KAM across industries, clarifying that their presence does not necessarily imply higher company risk. It also identifies industries that typically have more KAM due to their complex accounting requirements. Furthermore, it underscores that auditor and client characteristics play a role in KAM disclosure decisions. Ultimately, this understanding empowers stakeholders to make more informed decisions. The results of this study will also hold significance for regulators as they assess whether contextual factors influence the extended audit report and offer academia insights to enhance the knowledge and teaching of auditing practices. This study holds significance for auditors as it reveals reporting differences between Big 4 and non-Big 4 entities. It helps auditors grasp the impact of disclosing more KAM on report users and guides them in making informed decisions about what and how much to communicate. The goal is to highlight risks without overwhelming investors with complex terminology that may lead to misunderstandings. In conclusion, gaining insight into the current implementation and subjectivity of this standard benefits all stakeholders. It enables informed decision-making, improves KAM selection, and paves the way for refining the standard by reducing subjectivity, thereby further narrowing the expectation gap.

***In the final chapter***, this study delves into the audit report's quality, building on prior research that highlights how Key Audit Matters can mitigate aggressive financial reporting behavior,

enhance financial reporting and audit report quality, and also addressing the remaining two literature gaps identified in the first chapter. The specificity of KAM also improves user comprehension of disclosures and bolsters investor confidence in reported information. We argue that an effective KAM section elevates the overall audit report's communicative value, narrowing the expectation gap. To achieve this, the PhD thesis assesses KAM section readability using FOG and BOG indices and also studies two factors that are expected to influence the readability of KAM paragraph, namely: audit company type (Big 4 and non-BIG 4) and KAM type (entity or accounting level risk).

This study focuses on publicly listed companies on the Bucharest Stock Exchange, situated in Romania. This approach also addresses the necessity for research in emerging markets, particularly regarding financial reporting practices. The study is structured as follows: we have formulated three hypotheses for examination. H1 evaluates the impact of audit company type on the readability of the first paragraph of the KAM section, namely the description of the matter. H2 assesses the impact of audit company type on the readability of the second paragraph of the KAM section, namely the description of the audit procedures conducted to address the identified KAM and finally, H3 is assessing the impact of KAM type only on the readability of the procedures conducted to address the identified KAM. For H3, we focused solely on this paragraph as KAM descriptions are less intricate, potentially due to reduced litigation risk perception, but detailed audit procedures raise litigation risk, possibly influencing language complexity. In order to test the hypothesis, the study employs two methods: ordinary least squares (OLS) regression and hierarchical multiple regression analysis. OLS assesses relationships between a dependent variable and an independent variable, while hierarchical regression considers multiple predictors simultaneously, showing how they impact the dependent variable collectively.

Regarding the study's sample, out of the initial 82 companies identified as listed on the Bucharest Stock Exchange (BVB), 13 were excluded from the sample due to their involvement in the financial, banking, insurance, or financial intermediation sectors. These exclusions were necessary because these particular companies adhere to distinct financial reporting standards, resulting in audit reports that are not directly comparable to those of the remaining companies. As a result, the final sample consists of 63 entities analyzed over a four-year period from 2019 to 2022. During this period, a total of 229 audit reports were assessed, containing 414 Key Audit Matters (KAM). These reports were sourced from the websites of the listed companies,

and the KAM sections were manually transcribed into an Excel spreadsheet. For both the description of the matter and the audit procedures within the KAM section, readability indexes FOG and BOG were calculated using available online tools. Therefore, the study has utilized the following dependent variables: FOG KAM MATTER, BOG KAM MATTER, FOG KAM PROCEDURES, and BOG KAM PROCEDURES. The independent variables under consideration are audit company type and KAM type, while the study has also incorporated control variables including switch (indicating changes in the auditor from one period to another), size, leverage, ROA, years (a categorical variable denoting the audited year), and industry (a categorical variable representing the industry sector).

In summary, our analysis of the FOG and BOG indexes for both the KAM description and procedures sections revealed that the KAM description section demonstrates higher readability according to both indexes. However, both sections exhibit complex language and lack user-friendly terminology. The disparity in readability between the two sections can be attributed to several factors. Firstly, auditors utilize distinct wording when disclosing KAM descriptions and audit procedures. Secondly, the disclosure of audit procedures can heighten the auditor's exposure, leading to an elevated risk of litigation and increased level of responsibility. To mitigate these risks, auditors may use vague language in explaining the performed audit procedures. Lastly, the technical complexity inherent in audit procedures contributes to the disparity in readability between the two sections. Audit procedures often involve intricate methodologies, specialized terminology, and complex analytical techniques.

Additionally, our study identified revenue recognition, existence and evaluation of inventories, and impairment of property, plant, and equipment as the most frequently disclosed KAM. These areas represent highly complex features of financial accounting, necessitating detailed discussions and potentially higher-risk audit procedures. Moreover, both in Romania and the broader European context, auditors tend to highlight Revenue recognition as a KAM. This trend may be attributed to the significant risk of fraud in revenue recognition, as stipulated by ISA 240, prompting auditors to exercise increased vigilance in this domain.

With respect to the study's hypothesis, H1 and H2 were accepted, while H3 was rejected. We have observed that the type of auditor significantly affects the clarity and comprehensibility of Key Audit Matter descriptions and the associated audit procedures. Specifically, reports issued by Big 4 firms demonstrate higher levels of readability and understanding compared to those from non-Big 4 entities, which exhibit lower readability scores. This disparity can be attributed

to several factors. Firstly, Big 4 firms possess extensive experience, stemming from their frequent engagements with larger and more intricate clients, as well as abundant resources at their disposal. Additionally, the Big 4 firms' adherence to standardized practices plays a crucial role. These firms typically employ established methodologies and templates when crafting their KAM sections, ensuring uniformity and transparency throughout their reports. Moreover, Big 4 firms subject themselves to rigorous internal and external quality assessments to uphold their professional standards and reputation. They also provide comprehensive training to their professionals, ensuring strict compliance with specific reporting guidelines. Finally, the absence of support for H3, suggesting that the type of Key Audit Matters, entity-level risks, or accounting-level risks do not impact KAM procedures readability, may be attributed to differences in disclosure requirements. European companies adhere to more extensive International Financial Reporting Standards (IFRS) disclosures, while Romanian firms follow less complex requirements, affecting audit complexity. These contextual differences, combined with methodological variations, unaccounted factors, and random data fluctuations, contribute to the lack of statistical significance.

The study offers regulatory and supervisory insights, aiding companies in comprehending auditors' role in audit report clarity. Recognizing complex KAM types enables focused efforts for clarity improvement. Addressing KAM communication challenges can elevate audit report value and bolster trust in financial reporting and external audits, benefiting both academia and professional organizations through enhanced transparency and informed decision-making.

This chapter provides valuable insights to both agency and also stakeholder theory, but also to the currently available literature focused on audit quality, being also the first study to focus on an emerging country from Europe. The findings of this study have implications for standard setters who aim to enhance the usefulness of audit reports, as well as supporting the IAASB's belief that the introduction of KAM in the auditor's report can revitalize its relevance and value for investors. It also helps auditors realize the potential for improving communication and terminology to create more user-friendly reports with meaningful information and reduced risk of misinterpretation.

This thesis has some limitations. In the structured literature review (SLR), there's a limitation related to the relatively short time frame for ISA 701 adoption. Most research has focused on the UK, which adopted KAM reporting in 2013, affecting the analysis. Subjective observations and interpretations in the SLR could lead to differing results among researchers. The second

chapter has limitations due to recent ISA 701 adoption and data constraints. The third chapter's limitations include a short research period (2019-2022) and a sample limited to Bucharest Stock Exchange-listed companies. The absence of PwC also affects generalizability.

In summary, the PhD thesis successfully addressed the initial research questions, exploring various factors influencing KAM reporting and assessing the impact of ISA 701 on the audit report's communicative value. Our findings reveal that several contextual factors influence both the quantity and content of KAM, suggesting opportunities for enhancing how auditors communicate Key Audit Matters to stakeholders. This research offers valuable contributions to academia, auditors, and various stakeholders.