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The Effect of Disclosure of Major Audit Issues on the Relationship Between Credit Risk and Earnings Quality

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Abstract

This study examines the relationship between Credit Risk (CRI) and earnings quality, and the moderating role of Key Audit Matters (KAMs) in this relationship. Using a sample of 112 companies listed on the Tehran Stock Exchange from 2013 to 2022, the study employs a descriptive-correlational methodology and regression analysis to test two hypotheses. The results reveal a significant positive relationship between CRI and earnings quality, with higher CRI leading to greater earnings management. Furthermore, the disclosure of KAMs is shown to moderate this relationship by enhancing transparency and audit quality, thereby reducing earnings management in companies with higher CRI . The study's findings provide valuable insights for auditors, regulators, and investors, particularly regarding the benefits of KAM disclosure in improving the reliability of financial reports. Limitations include the exclusion of financial institutions and banks, as well as unaccounted political and economic factors. Future research should explore the broader impacts of KAM disclosures on corporate decision-making and risk management.

Keywords: Disclosure of major audit issues, Credit risk, Profit quality.

1 | Introduction

For many years, the relationship between audit quality and corporate financial reporting has been a focus of the research community. The purpose of auditing financial statements and internal controls is to assure financial statement users that high-quality information is available for use in investment and credit-granting decisions [1].

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The process of achieving audit quality can be summarized as detecting, adjusting, and reporting material misstatements, and attaining audit quality. Banks and financial institutions face various types of risk in their operations. In theory, eliminating all risks is not possible, but managing and identifying each risk within the bank is a proposed solution for risk reduction. Credit Risk (CRI) arises from banks' uncertainty regarding the ability of loan applicants or borrowers to repay the granted loans, or, in other words, from borrowers' unwillingness to fulfill their loan obligations or repay their facilities on time [2]. All credit institutions and banks encounter risks in their operations that cannot be completely eliminated. However, better management and high-quality audit reports can help mitigate these risks [3].

Key Audit Matters (KAMs) are issues that the auditor has discussed or should have discussed with senior management or members of the company's board of directors, as they represent topics of the greatest significance in conducting the audit. These matters may include complex issues that require evaluation by management or the auditor [4], [5] significant events or transactions that impacted the client's financial statements, areas involving substantial accounting estimates [6], or topics requiring consultation with experts or which the auditor found unusually challenging [7].

The auditor's report serves as a mechanism for communicating the results of the audit process to the users of financial statements. Users of audited financial statements have consistently expressed the need for more information regarding significant matters in the audit, often related to sections of the financial statements where substantial judgments by management and auditors have been applied [8]. Koç & Bayri [9] suggest that users are interested in more information about audit operations, management's analytical reports, accounting policies adopted by clients, and risk-related information. In fact, the current environment demands detailed and reliable information about business entities and the processes that support the quality of financial reports. Current shareholders, potential investors, and other users of financial reports seek to reduce uncertainty by accessing relevant and reliable information [10]. The results of the study by Daneshvar bondari et al. [11] revealed a significant relationship between CRI and the earnings quality of companies listed on the Tehran Stock Exchange. Additionally, four key earnings quality indicators—namely, stability, predictability, the relationship between earnings and cash flow, accruals, and the earnings response coefficient—were tested. The findings confirmed that there is a significant relationship between financial indicators, the credit rating of companies, and their earnings quality. Similarly, the results of the study by Chiang et al. [1]. demonstrated that the disclosure of KAMs moderates the impact of high CRI on earnings quality. In other words, the requirement to disclose KAMs such matters reduces the negative influence of high CRI on earnings quality. Furthermore, the evidence suggests that an increased frequency of key audit matter disclosures strengthens this moderating effect.

Given the novelty of KAMs in audit reports and the challenges they present due to auditors' professional judgment in determining such topics, it is essential to examine auditors' perspectives on KAMs.

When there is a prospect of a credit rating upgrade or downgrade, or in other words, when CRI in a company's environment increases, managers may manipulate the company's earnings by altering their accounting methods. Therefore, the first hypothesis of this research is as follows:

Hypothesis 1. There is a significant relationship between CRI and earnings quality.

Disclosing KAMs in the auditor's report can positively affect how users evaluate audit quality. This, in turn, enhances users' confidence in the audit process and financial statements. The International Auditing and Assurance Standards Board (IAASB) believes that presenting KAMs in the auditor's report: a) increases transparency of the audit process, and b) directs investors' and other users' attention to sections of the financial statements that require substantial management judgment and special attention from the auditor. This can assist investors and other users in better understanding the entity's financial position, the financial statements, and the outcome of the audit process as reflected in the auditor's opinion. As a result, it is expected that the disclosure of KAMs may reduce earnings management by companies with higher CRI. Therefore,

more frequent disclosure of KAMs indicates that auditors are conducting a more detailed review of the client's financial details. Consequently, the second hypothesis of this research is as follows:

Hypothesis 2. The disclosure of KAMs moderates the relationship between CRI and earnings quality.

2 | Methodology

Since the results of this research will be utilized by the Tehran Stock Exchange, the type of research is applied, based on its objective. The present study is descriptive-correlational in nature and method.

To test the hypothesis, the following regression model, adapted from Chiang et al. [1], has been used:

$$ABSD_{i,t} = B_0 + B_1CRI_{i,t} + B_2KAM_{i,t} + B_3KAM*TCRI_{i,t} + B_4DA_{i,t} + B_5Size_{i,t} + B_6LEV_{i,t} + B_7ROA_{i,t} + B_8GROWTH_{i,t} + B_9BIG_{i,t} + B_{10}CFO_{i,t} + B_{11}LOSS_{i,t} + \varepsilon_{it}.$$

Dependent variables

ABSD: earnings quality.

In this study, the dependent variable is earnings quality, which is measured using the real earnings quality index.

$$TACC_{it} / TA_{it} = \alpha_1(1/TA_{it-1}) + \alpha_2(\Delta REV_{it} / TA_{it-1}) + \alpha_3(PPE_{it} / TA_{it-1}) + \alpha_4 ROA_{it} + \varepsilon_{it}.$$

In the modified Jones model, total accruals are calculated as follows: TACC i, t = total accruals of company i in year t, which are calculated as follows:

$$TACC_{i,t} = (EBXI_{it} + FE_{it} - CFO_{it}).$$

EBXIi = net income of company i in year t compared to year t-1.

FEit = financial expenses of company i in year t compared to year t-1.

CFOit = operating cash flow of company i in year t compared to year t-1.

TA i, t-1 = total assets at the beginning of the period for company i.

ΔREC i, t = changes in accounts receivable and other receivables for company i in year t compared to the previous year.

ΔREV i, t = changes in revenue of company i in year t compared to year t-1.

PPE i, t = Property, plant, and equipment of company i in year t.

ε_{it} = The absolute value of the model's residuals, used to assess the quality of earnings.

Independent variable

Credit Risk (CRI): in this study, CRI is measured using the model developed by Hosseini, N., & Tajvidi [12]. In their research, they developed a model based on financial ratios that can, with 95.5% confidence, classify companies into three categories: high likelihood of default, weak likelihood, and zero likelihood of default. This model is also tailored to the economic structure and conditions of Iranian companies.

$$Zi = -0.783 - 1.719\,x1 + 2.34\,x2 + 1.813\,x3 + 10.768\,x4 + 1.987\,x5.$$

X1: ratio of total liabilities to total assets.

X2: working capital to total assets (current assets minus current liabilities divided by total assets).

X3: total asset turnover (sales divided by total assets).

X4: ratio of operating profit to total assets.

X5: ratio of retained earnings to total assets.

It is also worth noting that in this study, when the company-year is classified as having a high or weak probability of loan default (Z < 4.387), a dummy variable of one is used; otherwise, a dummy variable of zero is assigned.

Key Audit Matters (KAM): refers to disclosures regarding legal and economic factors. A dummy variable equal to one is assigned if the auditor's report includes comments on legal and economic factors that affect the company. If no information is provided on regulations or the market, this variable is assigned a value of zero.

Control variables

I. Accruals (DA): calculated as follows:

$$DA_{i,t} = (EBXI_{it} + FE_{it} - CFO_{it}.$$

EBXIi = net income of company i in year t compared to year t-1.

FEit = financial expenses of company i in year t compared to year t-1.

CFOit = operating cash flow of company i in year t compared to year t-1.

II. Company Size (size): calculated using the natural logarithm of the company's total assets.

III. Growth Index (GROWTH): the ratio of the difference between current year sales and previous year sales to the previous year's sales.

IV. Return on Assets (ROA): the ratio of net profit to total assets for company i in year t.

V. Financial Leverage (LEV): the ratio of debt to total assets.

VI. Operating Cash Flow (CFO): the ratio of operating cash flow to total assets.

VII. Company Loss (LOSS): assigned a value of one if the company is loss-making in the fiscal year, and zero otherwise.

VIII. Auditor Size (BIG): assigned a value of one if the company's audit is conducted by the audit organization, and zero otherwise.

The statistical population of this research includes companies listed on the Tehran Stock Exchange, with the time frame of the study spanning from the beginning of 2013 to the end of 2022, covering a period of 10 years. Given the conditions and limitations, a total of 112 companies listed on the Tehran Stock Exchange were selected. By considering the following criteria, a limited and purposive sample was derived from the population, which will be used as the research sample

Table 1. Sampling.

Description	Number
All companies listed on the stock exchange as of March 20, 2023.	643
Companies listed on the stock exchange after 2013.	(84)
Companies that were suspended or delisted during the research period.	(16)
Companies whose fiscal year does not end on March 20, or that have changed their fiscal year.	(162)
Financial intermediaries (investment, holding, leasing companies, and banks).	(67)
Companies whose shares were not actively traded on the stock exchange during the research period.	(83)
Companies that did not submit their 2022 financial statements at the time of this research.	(27)
Companies with insufficient data for some of the research variables.	(92)
Total sample, considering the assumptions.	112

Given the applied limitations, 112 companies from the Tehran Stock Exchange were selected as the study sample.

For data collection, two methods were employed: a library method (internet, books, articles, theses, and research reports) and the use of statistical reports and financial statements of the companies under review.

The raw data required for the companies were obtained to test the research hypotheses through software such as Rahavard Novin, Tadbirpardaz, and, in many cases, by directly accessing the financial statements available on CDs published by the Tehran Stock Exchange. For examining the theoretical and conceptual aspects of the research, the literature review and research background were conducted using the library method. Additionally, the field study method, which involved collecting and reviewing the financial reports and statements of the companies, was also used for data collection to perform statistical analysis of the hypotheses.

To analyze the data and test the hypotheses, the necessary data were collected from the audited financial statements of the companies for the 10-year period (2013-2022). After gathering the required information, the research hypotheses were examined using correlation analysis, regression, and panel data statistical methods. Initial calculations were performed in Excel to prepare the data for analysis, and then EViews software was used for final analyses. Given that the test data in this study are year-company specific, they are classified as panel data.

3 | Findings

Initially, descriptive statistical methods were used to analyze the data. Next, the normality test of the dependent variable was conducted. For model analysis, panel data regression was applied. It is important to note that the statistical data were analyzed using EViews 10 software.

Table 2. Statistical index of dependent and independent variables.

Variable	Symbol	Mean	Median	Maximum	Minimum	Standard Deviation
Earnings Quality	ABSD	0.08	0.06	0.81	0.0001	0.08
Accruals	DA	0.04	0.03	0.85	-0.83	0.15
Firm Size	SIZE	14.58	14.47	20.46	10.49	1.59
Financial Leverage	LEV	0.62	0.59	3.97	0.04	0.39
Return on Assets	ROA	0.12	0.10	0.69	-0.79	0.16
Sales Growth	GROW	0.15	0.19	0.99	-1.15	0.32
Cash Flow	CFO	0.11	0.10	0.86	-0.63	0.14

Table 3. Frequency of the research dummy variables.

Value	Frequency	Percentage	Symbol	Variable
0	197	17.59%	CRI	Credit risk
1	923	82.41%		
0	782	69.82%	KAM	Key audit matters
1	338	30.18%		
0	661	58.93%	BIG	Auditor size
1	459	41.07%		
0	954	85.18%	LOSS	Company loss
1	166	14.82%		

The mean is the most commonly used central tendency measure. It lies exactly at the balance point or the center of the data distribution. Variables are considered to have an appropriate quality when there is little difference between the mean and median. For example, the mean earnings quality, as the dependent variable for the sampled companies, is 0.08, and the median is 0.06. The maximum value represents the highest value of a variable in the statistical population. According to the table, the highest earnings quality for these companies is 0.81. The minimum value represents the lowest variable value in the statistical population. Based on the results, the lowest earnings quality for the sampled companies is 0.0001.

Table 4. Normality test.

Model	Jarque-Bera Statistic	Significance Level
Model 1	1.63	0.21

Given that the null hypothesis assumes the normality of the regression errors, the Jarque-Bera statistic indicates that the error distribution is normal, as the p-value is greater than 0.05 (Prob > 0.05).

Table 5. Results of the stationarity test for model variables.

Variables	Fisher Test	Significance Level	Result
ABSD	669.48	0.0000	Stationary
DA	591.28	0.0000	Stationary
SIZE	681.63	0.0000	Stationary
LEV	399.60	0.0000	Stationary
ROA	308.98	0.0001	Stationary
GROW	557.74	0.0000	Stationary
BIG	400.40	0.0000	Stationary
CFO	660.67	0.0000	Stationary

In the proposed models, following economic studies, the unit root test was conducted. The results of the unit root test for the regression residuals indicate that the significance level of the model variables is below 0.05. Therefore, based on the Fisher and Pesaran-Shin tests, the variables are stationary, and they do not contain unit roots. As a result, the estimated regression is not spurious.

Using the LM test, the presence of autocorrelation between variables can be examined, where H_0 indicates the absence of autocorrelation.

Table 6. Breusch-godfrey autocorrelation test (LM Test).

Model	F-statistic	Probability
Model 1	1.58	0.451

The LM test was conducted to examine the presence of autocorrelation. As shown in *Table 6*, since Prob>0.05, there is no evidence of autocorrelation in the model.

Table 7. Heteroskedasticity test.

Model	Test	T-Statistic	Probability
Model 1	Breusch-Pagan LM	1.7774	0.00000
	Pesaran scaled LM	13.97	0.0000

The results of the chi-squared statistics from the tests indicate that the null hypothesis of homoscedasticity is rejected. Therefore, the model exhibits heteroskedasticity. To address this issue, the Generalized Least Squares (GLS) method is used for model estimation.

Table 8. Examination of multicollinearity.

Variance Inflation Factor (VIF)	Research Variables
2.46	CRI
1.75	KAM
1.06	DA
1.15	SIZE
1.82	LEV
1.50	ROA
1.15	GROW
1.17	BIG
1.67	CFO
1.73	LOSS

If the VIF statistic is greater than 10, multicollinearity exists in the model. Based on the results shown in *Table 8*, the research variables do not exhibit multicollinearity.

Table 9. Model diagnostic test (fixed effects test).

Model	F-statistic	Probability	Comparison with 0.05	Test Result
Model 1	3.21	0.0000	Less than 0.05	Null hypothesis confirmed - Pooled model

According to *Table 9*, the significance level of the F-statistic for the regression models is less than 0.05. Therefore, it can be concluded that the null hypothesis H1 (pooled model) is confirmed.

Table 10. Hausman test.

Model	Chi-Square Statistic	Probability	Test Result
Model 1	60.64	0.0000	Null hypothesis rejected – Fixed effects model

Based on the Hausman test results in *Table 10*, the regression models of this study are best estimated using the fixed effects method within a pooled data framework.

Estimation of the first model

As explained in the diagnostic tests above, the Lagrange Multiplier (LM) test indicated that the data are pooled, and the model exhibits heteroskedasticity. Therefore, the GLS (Generalized Least Squares) method was employed to estimate the model, with the results shown in *Table 7*.

$$ABSD_{i,t} = B_0 + B_1CRI_{i,t} + B_2KAM_{i,t} + B_3KAM*TCRI_{i,t} + B_4DA_{i,t} + B_5Size_{i,t} + B_6LEV_{i,t}$$
$$+B_7ROA_{i,t} + B_8GROWTH_{i,t} + B_9BIG_{i,t} + B_{10}CFO_{i,t} + B_{11}LOSS_{i,t} + \varepsilon_{it}.$$

Hypothesis 1. There is a significant relationship between CRI and earnings quality.
Hypothesis 2. Disclosure of KAMs moderates the relationship between CRI and earnings quality.

Table 11. Results of the first model test.

Variable	Coefficient	T-Statistic	Significance Level	Impact
C	0.06	1.97	0.0489	Significant
CRI	0.005	3.77	0.0006	Significant
KAM	-0.01	-2.45	0.0143	Significant
CRI*KAM	-0.01	-3.15	0.0016	Significant
DA	0.12	2.50	0.012	Significant
SIZE	-0.0006	-0.29	0.7645	Not significant
LEV	0.006	0.76	0.443	Not significant
ROA	0.04	0.83	0.406	Not significant
GROW	-0.01	-2.43	0.015	Significant
BIG	0.009	1.18	0.237	Not significant
CFO	0.11	2.25	0.024	Significant
LOSS	0.01	1.74	0.081	Not significant

R-squared: 0.82.

F-statistic: 3.87.

Adjusted R-squared: 0.73.

P-Value: 0.0000.

Durbin-watson statistic: 2.03.

Hypothesis testing

For the first hypothesis of the study, the null hypothesis H0 and the alternative hypothesis H1 are as follows:

I. H0: there is no significant relationship between CRI and earnings quality.

II. H1: there is a significant relationship between CRI and earnings quality.

According to *Table 11*, the significance level between the two variables is 0.0006, which is less than the 5% significance threshold considered in this study. Furthermore, the absolute value of the t-statistic (3.77) exceeds 1.96, the standard normal distribution value at the 95% confidence level. Therefore, at the 95% confidence level, the null hypothesis, which states there is no significant relationship between CRI and earnings quality, is rejected, and the alternative hypothesis is confirmed. For the second hypothesis of the study, the null hypothesis H0 and the alternative hypothesis H1 are as follows:

I. H0: disclosure of KAMs does not moderate the relationship between CRI and earnings quality.

II. H1: disclosure of KAMs moderates the relationship between CRI and earnings quality.

According to *Table 11*, the significance level between the two variables is 0.001, which is less than the 5% significance threshold considered in this study. Additionally, the absolute value of the t-statistic (3.15) exceeds 1.96, which corresponds to the standard normal distribution value at the 95% confidence level. Therefore, at the 95% confidence level, the null hypothesis that "disclosure of KAMs does not moderate the relationship between CRI and earnings quality" is rejected, and the alternative hypothesis is confirmed.

4 | Conclusion

The results obtained from the first hypothesis indicate a positive and significant relationship between CRI and earnings quality. To explain this, it can be noted that when there is a prospect of an upgrade or downgrade in credit ratings, or in other words, when CRI in the company's environment increases, managers tend to alter their accounting methods in a way that manipulates the company's earnings and presents higher earnings quality reports. The results of the first hypothesis test align with the findings of Daneshvar bondari et al. [11]. In their study, the relationship between CRI of companies listed on the Tehran Stock Exchange and key indicators of earnings quality was examined. The findings of their research show a significant relationship between CRI and earnings quality indicators, which corresponds with the findings of this study.

The results obtained from the second hypothesis of the study indicate that the disclosure of KAMs moderates the relationship between CRI and earnings quality, effectively reducing the connection between these two variables. The reasoning behind this can be attributed to the fact that the disclosure of key audit topics in the auditor's report can have a positive impact on users' assessment of audit quality. This, in turn, increases users' confidence in both the audit process and the financial statements. The International Auditing and IAASB believes that presenting KAMs in the auditor's report results in: a) enhanced transparency of the audit process, and b) drawing investors and other users' attention to sections of the financial statements that require significant managerial judgment and heightened auditor scrutiny. This can help investors and other users better understand the company's financial position, the financial statements, and the audit process, as reflected in the auditor's opinion. Therefore, it is expected that the disclosure of KAMs can reduce earnings management by companies with higher CRI. The higher frequency of disclosing KAMs suggests that auditors are conducting more thorough reviews of the client's financial details. Consequently, managers are more likely to take corrective actions, such as recording adjusting entries, to improve the quality of the financial statements.

The results of the test for the second hypothesis are consistent with the findings of Chiang et al. [1]. Their study examined how the disclosure of KAMs could moderate the impact of CRI on earnings quality. The results indicated that the requirement to disclose these matters reduces the influence of high-credit-risk companies on earnings quality. In other words, greater disclosure of KAMs diminishes the strength of this relationship, having a moderating effect on the link between CRI and earnings quality.

One limitation of the present study is the limited familiarity of the country's auditing community with recent developments in the auditor's report, particularly regarding KAMs. Additionally, the political and economic conditions of the country, as well as the psychological climate in the Tehran Stock Exchange market, are factors that may influence the variables in this study but have not been controlled for. The study's population does not include financial institutions and banks; therefore, the generalization of the results to the banking and financial services industry is not feasible. Investors are advised to reduce potential specific risks in the stocks they purchase by diversifying their investments. By splitting their portfolio among several companies, they can aim to lower risk. This approach may also lead to a reduction in earnings management and, overall, decrease the risk associated with stock purchases. In fact, by investing in various companies from different industries and holding securities such as bonds, investors can mitigate the impact of a single event or decision that might significantly affect one company, industry, or type of investment.

Furthermore, investors are encouraged to select companies for investment that have exhibited less volatility in market performance indicators over the past five years, as this suggests lower risk and better risk management within the company. Overall, the findings of this study provide insight into Iranian auditors'

perspectives on what issues should be identified as KAMs, the advantages and disadvantages of disclosing such matters, and the guidelines and training needed for their proper implementation. Given the novelty of the KAMs section in the auditor's report, the findings of this research can offer valuable insights to the auditing standards-setting body, aiding in the appropriate adoption and implementation of the new Standard 701. Additionally, since no prior research has been conducted on this topic in Iran, the present study provides evidence for the auditing profession and academia regarding auditors' attitudes toward KAMs. As the primary reason for adding the KAMs section is to enhance transparency and provide more information to users, future research should investigate the impact of KAMs on earnings management by managers. Another area for future research could focus on the opportunities and challenges that the disclosure of KAMs presents, from the perspectives of auditors and investors—two critical user groups. It is also important to examine the effect of key audit matter disclosures on corporate investment decisions.

Author Contributions

Azim Salahi Kojour contributed to the conceptualization, data collection, and analysis of the research on the relationship between Credit Risk and earnings quality. Asiyeh Ahmadi Niyasani assisted with data interpretation, writing, and the analysis of the moderating role of Key Audit Matters (KAMs). Both authors contributed equally to the drafting and revision of the manuscript and approved the final version.

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Data Availability

The data used for this study is available from the corresponding author upon reasonable request.

Conflicts of Interest

The authors declare no conflicts of interest regarding the publication of this paper.

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