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ISA 701 links to corporate governance practices of South African state-owned enterprises

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ABSTRACT

Purpose: This study aimed to explore how auditors' applications of the International Standard on Auditing (ISA) 701 (communicating key audit matters) in independent auditor's report-principles link with corporate governance practices in state-owned enterprises, in South Africa. This was expected to provide insights regarding public sector auditors' views regarding ISA 701-links to the influencing of governance practices in state-owned enterprises.

Methodology: The study followed a qualitative approach, relying on interviews with senior external auditors and senior technical managers, who have a working knowledge of auditing state-owned enterprises in South Africa.

Findings: The study found that public sector auditors communicate certain matters to encourage effective oversight by those charged with promoting good governance. These matters include communication and emphasising matters that significantly impact financing decisions, as well as significant weaknesses in key financial controls.

Implications: The benefits of drawing management's attention to issues that could improve corporate governance, are significant. Regulatory authorities might consider extending the reporting of key audit matters to all state-owned enterprises, not just those that are publicly listed. Additionally, the insights provided by auditors can be leveraged by regulatory authorities to strengthen corporate governance within state-owned enterprises.

Originality/Value: The study contributes to understanding the value of adopting international auditing standards to the broader corporate governance ecosystem, using evidence from the public sector within an emerging economy.

Key words

Accountability, internal controls, key audit matters, stakeholders, state-owned enterprises, transparency

1 INTRODUCTION

South African state-owned enterprises (SOEs) are expected to embody transparency and accountability, which is the foundation of good governance (Organisation for Economic Co-operation and Development [OECD] 2020). However, in South Africa, governance challenges have been (and still are) faced by South African SOEs, emanating from a complex network of procurement fraud, involving high-ranking politicians, public officials and private businesses. These have had such a dire impact on SOEs and the country's fragile economy, that an academic term for it emerged, namely "state capture" (Alence & Pitcher 2019). The Judicial Commission of Inquiry into Allegations of State Capture recently reported that, during the previous administration (2009–2018), the performance of many SOEs declined, as these entities were wracked by corruption, fraud, and a lack of accountability and consequence management for those responsible (Zondo Commission 2022). Public service provision cannot be effectively and efficiently realised without adequate governance of SOEs, of which auditors form an important part (Grossi *et al*. 2015).

In an audit of financial statements, the audit report is a mechanism through which independent auditors express their views on the financial performance and position of a client, to the users of the financial statements (Rautiainen *et al*. 2021; Segal 2019). The International Auditing and Assurance Standards Board (IAASB) has framed the auditor's report as a means by which the auditor communicates the outcomes of the audit process to the users of the financial statements (Aqel 2014). The importance of financial and performance reports to South African SOEs is

emphasised and governed by the Public Finance Management Act (PFMA) 1 of 1999 (Republic of South Africa [RSA] 1999). The act requires the government to account for its actions in so far as the public purse is concerned, and to have those accounts audited by the Auditor-General South Africa (AGSA), in line with the Public Audit Act 25 of 2004 (Moyo & Monkwe 2017; RSA 2004).

However, audit reports have often been criticised for lacking accountability and transparency, as it does not necessarily provide adequate insight to the users of financial statements, on the audit's critical issues, and how the auditor has dealt with these issues (Rautiainen *et al*. 2021). In response to this criticism, the IAASB issued the International Standard on Auditing (ISA) 701. This standard deals with the requirements for the disclosure of key audit matters (KAMs) in the auditor's report. Per ISA 701, KAMs are financial reporting matters that, in the auditor's professional judgement, require significant auditor attention during the audit (IAASB 2015). KAMs are frames of how individual auditors have interpreted, observed, and understood areas of significant risk. Prior studies have mostly focused on the information/communication value of ISA 701, in reducing information asymmetry. There is a lack of studies that examine ISA 701 as a mechanism through which auditors can influence good, day-to-day corporate governance practices (Kitiwong & Sarapaivanich 2020).

This study aimed to evaluate how public sector auditors understand the process of developing a KAM-framing, to evince links with corporate governance practices in South African SOEs. The South African public sector has continued to face significant challenges concerning financial mismanagement and an overall poor control environment at SOEs, as evidenced by recurring, negative audit outcomes, reported by the AGSA (AGSA 2021). In order to improve good governance, that SOE stakeholders have perceived as lacking (AGSA 2021; Sithomola 2019), auditors need to contribute positively to corporate governance practices, using auditing standards and guidelines. There is a research gap concerning studies that evaluate how external auditors' execution of the work required by auditing standards, becomes linked to corporate governance practices. This study responded to this research gap, by investigating the strategies that auditors have employed to ensure that ISA 701 positively links to corporate governance practices in SOEs. Studies on KAMs have predominately focused on evaluating those matters being reported as KAMs—mainly in the private sector (Barghathi *et al*. 2021; Kitiwong & Sarapaivanich 2020; Nguyen & Kend 2021; Rautiainen *et al*. 2021; Segal 2019). None of the studies have specifically focused on entities operating in the public sector, so as to gain the opinions and views of public sector auditors, regarding the effect of the implementation of KAMs on public trust in the audit process, and on transparency and accountability. Segal (2019) interviewed South African experts regarding their perspectives on KAMs, however, these experts were limited to individuals who audit private companies. The study by Rautiainen *et al*. (2021), not only did not focus on the public sector, but presented a European perspective and, therefore, the findings may differ for emerging economies, such as South Africa. Kitiwong and Sarapaivanich (2020) did not conduct interviews, rather executing a logistical regression, using data from private companies. Nguyen and Kend (2021) focused on various stakeholders in Australia but, once again, did not take into account the perspectives of public sector auditors on KAMs.

Hence, this study addressed the lack of first-hand evidence aimed at gaining an understanding of KAMs from the perspective of auditors in the public sector, and contributes to the existing literature by providing findings and insights that link auditing standards to corporate governance—an area that has been largely neglected in the literature.

2 LITERATURE REVIEW

In many countries, SOEs face the same challenges and opportunities as private sector entities, however, in the case of SOEs, in addition to maintaining financially viability, it is required to also create public value for citizens (PricewaterhouseCoopers [PwC] 2015b). Some of the benefits SOEs receive, include preferential treatment by and advantages from the government, such as access to cheaper funding, government-backed funding guarantees, and other privileges enabled through the passing of legislation in its favour (Chitiga-Mabugu *et al*. 2022). The focus of SOEs is on magnifying societal value creation, by facilitating the government's service delivery pertaining to various elements of economic and social development, such as talent, as well as both financial and non-financial resources (PwC 2015b).

2.1 SOEs in South Africa

Proper governance structures are essential for SOEs to perform optimally, and to deliver on its mandate (Hendricks 2024). Not only do SOEs contribute to the economic growth of a country, it also significantly impacts the lives of the citizens of a country (Ackers & Adebayo 2022). Although SOEs play an important role in the South African economy, several vital South African SOEs have faced crippling challenges, that have threatened its continued viability and organisational legitimacy (AGSA 2021; Cheteni & Khamfula 2018). Challenges confronting SOEs include excessive politicisation, corruption, multiple and conflicting mandates, inadequate financing, lack of adequate oversight and accountability, severe weaknesses in board composition and functioning, and lack of transparency and accountability (Kikeri 2018). Lack of oversight results from a lack of decisive political leadership, that fails to interrogate and inspire change in the financial- and operational performance of SOEs; and weakened influence and impact of the board of directors, caused by different factors, such as conflicts between CEOs and chairpersons, lack of succession planning, political interference, nepotism, lack of appointments in senior positions, and appointment of individuals who do not have the necessary experience (Thabane & Snyman-Van Deventer 2018; Thomas 2012).

As a consequence, there is a lack of accountability, as key structures of oversight, namely portfolio committees

and boards of directors, fail to affect the internal control and risk management practices of SOEs (Mutize & Tefera 2020). The instability experienced in the oversight leadership of SOEs has even caused the turnaround plans intended to transform SOES, to fail (Mpete & Maier 2024). Other issues emanate from a lack of ethical behaviour amongst internal leadership (executives and managers) related to public procurement—an area permeated by fraud and corruption—in a process where most state funds are used in SOEs (Nzimakwe 2023). SOEs, such as South African Airways (SAA) and Eskom, have continuously required significant financial bailouts by the government, owing to its ongoing concern challenges—running the risk that it may become completely dependent on such bailouts (Kanyane & Sambo 2021). Although SOEs should aim to reduce government debt, South African SOEs increase such debt, by requiring and receiving billions in bailouts (Marimuthu 2020). The continued support for failing and mismanaged SOEs contributes to its declining performance, and encourages poor decision-making and the mismanagement of resources (Marimuthu 2020). This is ascribed to SOEs receiving these bailouts, as opposed to being held accountable for its actions, and the issues and wrongdoings being addressed (Mpete & Maier 2024).

2.2 Stakeholder theory

In the context of SOEs, that are primarily intended to operate for the benefit of societies, the term "stakeholder" refers to government funders, ordinary citizens, civil society organisations, and other consumers of the goods and services it provides (Oates 2013). Although the information-needs of all stakeholders should matter to SOEs, stakeholders have varied levels of power, legitimacy, and urgency. Those who enjoy significant levels of power, legitimacy, or urgency are likely to be accommodated to a greater extent, when external reports are being prepared (Donaldson & Preston 1995).

Stakeholder power

Stakeholder theory provides a useful tool for understanding the interaction between power, urgency, and legitimacy amongst stakeholders with reporting practices (Friedman & Miles 2006). To achieve transparency and accountability through audit reports, the auditor must be cognisant of stakeholders that are crucial to the SOE's success and sustainability, and those should be treated as important, and their information-needs should be managed effectively, to reflect the power they possess (Freeman 2010).

Power over an SOE is reflected by the stakeholder's level of influence and control over the sustainability prospects of the SOE (Donaldson & Preston 1995), e.g., politicians enjoy high levels of power, as they control the budget allocation, policies, and legislation that govern SOEs. The nature of the relationship provided by the legislative and political structures, renders politicians powerful in relation to SOEs.

2.2.1 Stakeholder legitimacy

Stakeholder legitimacy speaks to the degree to which a particular stakeholder is perceived or assumed to contribute positively to the SOE, at a particular time and place (Friedman 2007). If a stakeholder is perceived to render a more positive contribution to the operations, finances, and sustainability of the SOE, then management and auditors are most likely to prioritise the information-needs of that stakeholder, at the expense of the others (Suchman 1995). The legitimacy of a stakeholder depends on the specific circumstances and factors, for the matter currently under evaluation. For matters related to financial risks and auditing matters, parties who are perceived to contribute positively to these may differ to those in a situation where political- or policy-matters are under consideration (Friedman 2007). Not all stakeholders perceive other stakeholders as having the same level of legitimacy (Suchman 1995)—it is therefore important that the information-needs of the most legitimate stakeholders are addressed, as this improves the legitimacy of the SOEs, in the eyes of other stakeholders (Larson *et al*. 2015).

2.2.2 Stakeholder urgency

Stakeholder urgency speaks to the degree to which a particular stakeholder's claims inspire immediate action from the SOE (Mitchell *et al*. 1997). Ideally, all stakeholders' needs should be regarded with the same level of urgency, however, in reality, those stakeholders with higher resource contributions and power have higher weighting requests (Mossberg & Getz 2014). When the political head requires an SOE to engage in a particular project because they have publicly committed to it, the SOE will have to act with urgency, owing to the degree of power, public impact, and political weight of the requester. Stakeholders who possess all the attributes of "power, legitimacy, and urgency" often can significantly influence and exert pressure on the corporate governance and reporting practices of SOEs (Oates 2013). It has been found that SOEs struggle notably with balancing the conflicting needs of different stakeholders, and this contributes to transparency challenges. This is because, although SOEs are expected to provide all stakeholders with the information required for decision-making, there are cost-benefit considerations, and there is also information issues, such as KAMs that are only suitable and appropriate for stakeholders who have the technical understanding of and use for such information.

For public sector entities to continue to survive, it needs to ensure that it conforms to social norms and remain legitimate in the eyes of the government, ordinary citizens, civil society organisations, and other consumers (Oates 2013). One of the means through which this is achieved (Oates 2013), is by regular reporting to the general public (including funders and trade unions), on the financial and operational performance of these entities, as well as government oversight structures that monitor the functioning of such entities. The lack of a proper flow of information between the SOEs, the public, as well as parliamentary structures, will result in information asymmetry, as those who are appointed to manage public resources and those whom they are intended to serve will not have access to the same information (Stiglitz 2002). Access to accurate and complete information is essential to any democracy, as well as for the proper

functioning of the country's capital markets (Florini 2002).

The main motivation for the establishment of ISA 701 was that KAMs would improve communication value, allowing the stakeholders to understand the process undertaken by the auditor in responding to significant risks (Gambetta *et al*. 2023). There is growing acknowledgment that KAMs have improved the communication value of audit reports (Giorgi 2017). The auditors have the power to influence financial processes—communication in audit reports concerns inclusions and exclusions of certain aspects of reality, whilst placing particular emphasis on those aspects that support the legitimacy of the audit process, and direct the narrative in a manner that will suit the most powerful stakeholders expected to use the report, e.g., banking institutions (Entman 1993).

An understanding of financial and governance reality, when it comes to the application of ISA 701, is important, as it underlines the impact of new audit standards in the corporate governance ecosystems, that reflect the value outside of the impression management and legitimacy-building process of information communicated in an audit report (Kaplan 2008). Auditors can use audit reports to ensure that they are perceived in a favourable light by stakeholders (Merkl-Davies & Brennan 2011). The image of auditors has been negatively impacted by the recent fraud allegations and corporate failures, and audit reports can provide an opportunity to—consciously or unconsciously—attempt to repair this image (Melloni *et al*. 2017). In times of increased public scrutiny, more positive information can be provided to the users of audit reports, *via* KAMs (Brennan & Solomon 2008). KAMs provide an opportunity for the auditors to display their understanding of significant risk areas, and positively communicate the work that was performed, that will assist to build a positive image. Audit reports can be used to sell particular narratives, that are not reflective of the behavioural realities (Snow & Benford 1988). The light must be shed on how audit frameworks and principles are applied in a manner that impacts practices on the ground, beyond the potential greenwashing reported in a KAM paragraph (Brivot *et al*. 2017). This understanding helps in constructing the meaning-value of audit reports (Hyndman & Liguori 2023). Investors use the auditor's report to make informed decisions about how the organisation, as a whole, is being governed (Robu & Robu 2015).

In recent years, criticism has been levelled against the auditor's report, as it has been perceived as being insufficiently useful in improving the corporate governance landscape (Gold & Heilmann 2019). This criticism has been fuelled by a series of corporate collapses and audit failures, that have resulted in perceptions of audit quality being at issue, over recent decades (Kilgore *et al*. 2011). These corporate failures have threatened the credibility of the audit function, particularly with regard to audit quality (Kilgore *et al*. 2011). In developing countries, especially, the issue of corruption has been observed to add to the existing complexities related to the credibility of audit reports, and that has resulted in auditors being doubted even more, as it pertains to their independence, integrity, and objectivity (Modugu *et al*. 2012). Examples of corporate scandals, where auditors received public scrutiny, include the collapse of South African retailer Steinhoff, where instances of accounting irregularities and lack of transparency were discovered (Rossouw & Styan 2019).

On account of to the importance of auditing perceptions in enhancing the credibility and reliability of corporate governance (Kilgore *et al*. 2011), the audit environment has been affected by considerable changes relating to the nature of the audit work performed in the last decade, as well as increasing pressure on auditors to be more transparent in their work (Segal 2019). Some of these changes, as they relate to the audit report, have focused on requiring auditors to highlight issues that they judge of importance to users of the financial statements (Rautiainen *et al*. 2021). The introduction of ISA 701 by the IAASB, concerning key audit matters, is one such change that affects the auditor's report. ISA 701 was issued in response to calls from stakeholders, requiring auditors to provide more relevant information that will help them evaluate the overall performance of organisational corporate governance (Nguyen & Kend 2021).

KAMs are decided on by considering areas in the financial statement, that pose significant risks of inaccuracy or management discretion (Rautiainen *et al*. 2021). Accordingly, "KAMs are financial reporting matters that, in the auditor's professional judgment, require significant auditor attention during the audit" (IAASB 2015:3). In terms of ISA 701, the purpose of KAMs is "to enhance the value of the auditor's report by providing greater transparency about the audit that was performed" (IAASB 2015:3), i.e., highlighting financial reporting risks to the users of the financial statements, intended to improve the communicative value of the audit report (Nguyen & Kend 2021). ISA 701 further indicates that this additional information, provided in the form of KAMs, can assist users of financial statements in understanding which matters were most significant, concerning the audit. In a way, KAMs will allow investors to be aware of what areas of the audit "kept the auditor up at night" (PwC 2015a).

On 15 December 2016, auditors of South African SOEs that have shares, stock, or debt instruments listed on the JSE, were required to disclose KAMs in their reports, for the first time (Segal 2019). The requirements to include disclosure of KAMs in the audit report impacted reporting in the public sector as well, as several SOEs in South Africa have debt instruments listed on the JSE. For those SOEs, with shares, stocks, or debt instruments listed on the JSE, the disclosure of KAMs is compulsory, however, for the remainder of SOEs, such disclosures are not compulsory.

3 METHODOLOGY

The study relied on semi-structured interviews with public sector auditing experts, where seven open-ended questions were posed. The research agenda questions were guided by the research purpose, and developed in line with prior literature on KAMs, accountability, and transparency. The researchers deemed semi-structured interviews appropriate for data collection, as it allowed participants to describe

their account of the impact of KAMs, based on their experience with KAMs. The research agenda was tested for appropriateness of design and relevance, *via* pilot interviews with two experienced academics, who are former governing body members at SOEs (Rowley 2012).

The study purposively selected research participants, based on their work experience in auditing SOEs. The focus on experience and in-depth knowledge, ensured against researchers bias, and helped the study achieve trustworthiness of the data source, which aided the relevance and richness of the analysis and findings (Maroun & Solomon 2014). On account of the involvement of human participants in the study, ethical clearance was obtained from the research ethics committee at the University of the Witwatersrand, prior to commencement of interviews. This ensured that the rights, dignity, and confidentiality of the interview participants were protected (Leedy *et al*. 2019).

Participants were asked six probing questions, that were purposefully directed to build up to the main question and aim of the study, which was to understand the impact of KAMs. Given that the interviews were semi-structured, further probing questions were posed to participants, based on their individual reflections. The research questions for this theme were adapted from Segal (2019), Bowlin (2011), and Asbahr and Ruhnke (2019) and were presented as follows:

1 What is your understanding of a KAM?
2 What factors are considered when reporting a matter as a KAM?
3 Would you consider the decision to report a KAM as easy or difficult, and why?
4 How do you think the disclosure of KAMs has impacted the user's understanding of what the auditor is doing?
5 How have KAMs impacted corporate governance practices/activities?
6 How have KAMs resulted in value for key stakeholders?

A total of 12 research participants were interviewed, *via* Microsoft Teams. Interviews ranged from 45 minutes to 75 minutes in length (refer to Table 1). Given the inherent limitation of a small sample size, the study compensated by focusing on interviewing experienced senior auditors, who were involved in SOEs that had debt instruments issued on the JSE, which affected a small number of SOEs. The duration of the interviews allowed for in-depth perspectives to be explored, which added to the richness of the data collected.

Table 1: Overview of interviewees

Position	Total years collective audit experience	Duration of the interview
Technical Audit Manager – (Acting Senior Audit Manager) (R1)	6 years	50 minutes
Senior Audit Manager (R2)	12 years	53 minutes
Senior Audit Manager (R3)	11 years and 4 months	53 minutes
Senior advisor (R4) – Former Senior Audit Manager	27 years and 6 months	45 minutes
Acting Senior Audit Manager (R5)	9 years	58 minutes
Senior Audit Manager (R6)	14 years and 6 months	75 minutes
Senior Audit Manager (R7)	20 years	68 minutes
Senior Audit Manager (R8)	10 years and 8 months	57 minutes
Deputy Business Unit Leader (executive level auditor) (R9)	13 years and 4 months	56 minutes
Senior Audit Manager (R10)	13 years and 2 months	61 minutes
Senior Audit Manager (R11)	9 years and 7 months	48 minutes
Senior Audit Manager (R12)	7 years and 5 months	68 minutes

(Source: Own)

Auditors are required to maintain the confidentiality of client information. In addition, auditors in the public sector are often faced with intimidation and threats, which necessitated measures, such as interviewing auditors who have had exposure to more than two SOEs, to ensure that participants' reflections were not limited to a specific SOE. Any direct references that might identify a participant or the SOEs, were deleted from the transcript, prior to review by the participant. Research participants were allowed to highlight any areas that might constitute a breach of confidentiality, in their transcripts, before it was used in the analysis.

Once the transcript was reviewed by the research participant, the researchers perused and considered the transcripts at least three times, in order to gain a sense of the content and the main issues raised by participants, guided by the literature reviewed. Following the third reading, the content of each transcript was classified into the main common themes that emerged, again, guided by reviewed literature (Leedy *et al*. 2019). A theme register was maintained in Microsoft Excel, that enabled the tracking of themes.

The themes were allocated codes, in the words of the interviewee, so that the texts of similar themes were grouped together (Rowley 2012). To avoid researcher bias in the data analysis, the open code themes were derived solely based on what the participants said, as evidenced by the transcripts, rather than relying on the literature that had been reviewed. Finally, transcripts were analysed, similar themes or codes were aggregated, and the transcripts were re-evaluated to ensure accurate, complete and consistent coding. Open codes were recorded on a theme register, that tracked the number of codes per transcript, the frequency of codes, and any similarities or contradictions amongst respondents.

4 RESULTS

The results of this study showed that ISA 701 provides detailed guidance on how auditors should identify and report on a KAM, in a particular, the order of logic, so as to develop links between KAMs and corporate governance practices in SOEs. This study found that the following logic needed to be applied by public sector auditors, when identifying KAMs that would yield value to the corporate governance ecosystem:

1 Define key stakeholders and their information needs.
2 Identify areas of key corporate governance weaknesses.

4.1 Define key stakeholders and their information needs

Auditors need to define what characterises a KAM, by identifying the power, legitimacy, and urgent information needs of the intended reader of the KAM paragraphs. All respondents reflected that, in South Africa, the audit reports for SOEs are mainly read by debt providers and parliamentary committees, though with different powers, legitimacy, and urgency. Respondents argued that the value of an audit report lies in its ability to respond to the information-needs of the most powerful, legitimate, and urgent readers. This process reminds those charged with governance to focus on responding to the needs of key stakeholders.

4.1.1 Stakeholder power

To develop a deep connection and understanding with the reader of an audit report, the writer must express information that is believed to be material. Auditors, as writers of the audit reports, must have the ability to use KAM paragraphs to generate and manipulate the reader's understanding of risk, emanating from significant judgement, complexities, and estimates (R1, R2, R3, R4, R5, R6, R7, R8, R9, R10). For example, R4 made the following remarks concerning what they considered, when deciding whether a matter was a KAM:

> *Well, obviously it's going to have to be a material account balance or class of transaction. So that is one of the critical criteria. Then, as I did indicate, where management applied certain judgements or assumptions, it could be a highly complex matter, that needs the involvement of maybe an expert. So, typically, where you would use, maybe, an actuary or a property valuator, etcetera, to be able to analyse that data and, yeah, those would be the key things and something, well, in the public sector, what we look at, is also what is the interest of the users of financial statements and, typically, that would be, obviously, the parliamentary committees. So is it something of interest to them? Is it something that could concern them? So those would be the additional criteria that I would apply.*

Respondents explained how parliamentary committees had the power to influence the activities of SOEs, as those charged with governance, together with the minister, must account to the portfolio committee, on performance. This grants portfolio committee members the powers to question, recommend, and follow up on SOE action plans, thus granting them powers and legitimacy, owing to their perceived positive contributions to the SOE's future prospects (Friedman & Miles 2006).

When politicians understand their influence and responsibility to ensure that the financial risks of SOEs are responded to, this will elevate their power concerning financial reporting and auditing, forcing auditors to prioritise and balance their information needs. This result indicated that there is an opportunity to use KAMs as a tool, towards enhancing the effectiveness of the financial oversight and accountability provided by members of Parliament. Auditors have had to use language that is understandable to parliamentary members, to enable them to appreciate valuable information concerning risky or contentious areas in the financial statements, that have seen an increase and where they should be focusing more, in their financial oversight role.

> *R7: So, in the experience that I've had is that, yes, we've included some of those KAMs, but in the sessions of dealing with the audit report, in Parliament for portfolio committees and for debrief to ministers, you would often still have to explain to them what is it that we are trying to say in the KAMs. Initially, it was often misinterpreted as being part of the audit outcome or basis for the audit outcome and, I think you know, we can't fault them for not understanding because, you know, they read it and it smells and it looks like our typical basis for modifications and therefore they interpret it in the same way…overall, it is your job, as the auditor, to make them understand the value of financial matters, and [they] these things matters for their oversight.*

The finding implied that KAMs have caused auditors to alert members of parliament on how to effectively execute their mandate of ensuring effective enforcement of their power of financial oversight and accountability, regarding the affairs of the SOEs. More still needs to be done, to ensure that parliamentary committees fully utilise the value of KAMs to direct its decisions. As KAMs are usually contentious matters, that auditors would have spent significant time on, improved financial oversight over crucial areas of financial reporting will only transpire if parliamentary committees understand the information included in the KAMs, and when they are also likely to understand the related information, as included in the annual financial statements of the SEOs (R2, R7, R9).

The study found that when auditors develop a KAM in SOE audits, they must have the understanding that KAMs are only valuable to capital market participants—little value is provided for parliamentary committees, owing to its avoidance and non-appreciation of the overall impact of technical accounting matters in decision-making. This is consistent with the fact that capital providers will possess more power to direct reported financial accounting information as, with the current dire state of South Africa's fiscus, SOEs are looking more towards debt- and equity providers, to contribute more to its

financial viability. This lends debt- or equity providers, such as banking institutions, increasing power to influence the reporting of KAMs by auditors. With the knowledge that financial risk information is crucial to debt providers' decision-making process, auditors need to report KAMs that are included in the key considerations by banking institutions, when making financing decisions.

Respondents identified that, although politicians also provide SOEs access to funding, they lack interest in the underlying financial risks, inherent to the SOEs. This practice is problematic, as it highlights the fact that politicians continuously confer public resources on SOEs, without any meaningful consideration of the risks that this poses to the financial viability of the state. Respondents identified that there is a need for politicians to be educated and supported, in order for them to identify that the financial performance and position of the SOE are reflected by more than just the audit opinion, and that key risk areas must be understood and used, to inform their decisions. KAMs present an opportunity to educate oversight committees on the snowball impact of technical accounting matters, and on the financial position and performance of the SOE that, ultimately, impact its ability to obtain financing (R3, R4, R9).

4.1.2 Stakeholder urgency

It was clear that respondents were of the view that, when it came to KAMs and financial management matters, portfolio committees did not display a high level of urgency.

> *R8: The issue that I have seen…members of SCOPA would summon the executives, board members, and the minister to answer questions, and you find that the executives don't even bother to pitch, only the board chair is there…they don't take these committees with the seriousness they deserve.*

> *R5: What can you say when the portfolio committee on transport makes recommendations but the SOE does nothing, like no actions…the impression is that they are not committed to act and these committees can only recommend, sadly.*

> */ information that they know, very well, [they] will not change their position…bailouts have been normalised in the current system.*

Members of parliament, supposed to provide oversight concerning the affairs of SOEs on behalf of the general public, exhibit very little—if any—interest in KAMs (R1, R3, R4, R6, R7, R10). In relation to KAMs, politicians have low levels of power to influence what is being reported by auditors. Owing to their lack of interest, understanding, and impactful reaction to the KAMs reported, auditors focus on other stakeholders with higher levels of urgency, concerning the reporting of financial performance. Respondents indicated that the ability of parliament oversight committees to derive value from the information reported as KAMs, is negatively impacted by the fact they are only interested in the auditor's opinion and qualification (R3, R4, R7, R8). If the audit opinion has not been affected, parliamentary oversight committees do not develop a changed view of the financial risk of the SOE, rendering the reported KAMs less useful in terms of their decision-making.

> *R7: I think there is an emphasis on only wanting to know whether it's a qualified opinion or unqualified or disclaimer, and what causes us to get to that outcome is not always too much of a discussion point, or item to really get to the bottom of, which I think is wrong.*

> *R8: When you go to Parliament and those are elected public representatives, most of the time they [are] obviously only looking at one paragraph in the audit report that says, "in my opinion, the financial statements fairly represent", you know, "in all material respects".*

Respondents were asked about strategies that they employed, in an attempt to balance the delivery of the technical details of KAMs, in that it may serve both parliamentary committee members and debt/equity providers. They suggested that, with reference to parliamentary committee members, the focus was on the delivery of KAM information during meetings, where there was an opportunity to explain technical jargon in a simplified manner. Whereas the technical language in written audit reports is more suited to debt providers, who have a technical understanding, and their engagement is only in the form of written text, parliamentary committees have an opportunity to engage more on the KAMs. Currently, the lack of parliamentarian understanding of technical financial matters, reduces the urgency of those charged with governance, in terms of providing them with such information and regarding their engagement with technical accounting risks, seriously.

> *R7: You need to strike a delicate balance between making technical information understandable to the audience, and providing in-depth technical details for those with specialised knowledge*.

Despite the challenges posed by the use of technical language in KAMs, respondents also indicated that, owing to the nature of the matters typically reported as KAMs, there was a need to make use of technical accounting- and auditing terms, so as to fully explain the issues, as well as what the auditor has done, in order to deal with it (R1, R3, R4, R6, R7).

> *R1: There is still a need to include some technical jargon in KAMs, and this information is only useful to users, provided they already have some understanding of accounting/auditing.*

The use of such technical language hampers the ability of a number of parliamentary committee members to fully understand the KAM disclosures, and meaningfully engage with it. This is consistent with findings by Bédard *et al*. (2019) and Segal (2019), on the impact of technical language on users' ability to understand and react to KAMs. Several respondents further indicated that the use of such technical language created a risk that the KAMs might be misunderstood by some users of the report, as modification areas (R2, R7, R8, R9, R10).

When respondents were further questioned, concerning the way that the issues on the use of technical language were addressed, R7 stressed that an experienced auditor must be mindful that they would not be writing with the general user of the audit report in mind. R6, however, indicated that, although the language used in KAMs was technical, it was consistent with the language used in other sections of the audit report, and that this has resulted in auditors having to spend more time in meetings explaining the entire audit report, in familiar, understandable language, without omitting important technical details. R8 shared a similar view, in that they believed that the language used in crafting the KAMs was still appropriate, as financial market members—the key readers of KAMs—want to know the technical details. With regard to members of parliament, the technical details are explained to them in meetings, where the audit report is tabled. They learn the understand the value of KAMs *via* these engagements (R1, R2, R3, R4, R7, R8, R9, R10,R11).

> *R5: So, when it comes to KAMs, we do have [a] specific working papers that we complete. It's mainly just a transfer from the prior years, in terms of the data, and then there's just certain adjustments that we have to remember, if there is changes then on, for example, the ECL amount during the audit, and then we have to just make sure we go back and update the working papers [and] also update the reports.*

SOEs often participate in the financial markets through the issuing of debt instruments. Respondents recognised that the providers of capital or financing for the SOEs, were also key external users of the audit reports, as they used such reports in risk assessment, and to continuously monitor whether these entities were adhering to its debt covenants (R1, R2, R3, R4, R6, R7, R8, R9). Respondents indicated that international providers of capital and financing placed more reliance on KAMs, as a tool that renders additional insights into the areas in the financial statements that carried the most risks, and this information was factored in loan consideration and capital discussions (R1, R2, R3, R4, R6, R7, R8). The financial contributions of capital providers lends legitimacy to SOE-needs.

4.1.3 Stakeholder legitimacy

Research has evinced that those stakeholders whose actions will significantly impact the financial viability of the SOEs, will enjoy high legitimacy, and KAMs will be prepared with their financial risk information as a priority. When auditors focus on such stakeholders, the actions of management are then also likely to focus on ensuring that risk management strategies concerning such financial risks are enhanced, so that a positive picture is presented to influential stakeholders, in order to secure future sustainability (Donaldson & Preston 1995). At present, scarce value is provided to parliament committees, on account of its avoidance of and its non-appreciation of the overall impact of technical accounting matters, in its decision-making. This denotes that parliamentary committees must start to mindfully consider KAMs, when reaching decisions on the allocation of budget, government bailouts or guarantees. By so doing, they will begin to exert high levels of legitimacy, that will inspire action by those charged with the governance of SOEs.

This study found that capital market participants held high levels of legitimacy, as it pertained to financial- and audit reporting, specifically with regard to KAMs. Respondents noted that auditors needed to acknowledge that KAM paragraphs were mainly read by participants in the capital markets, such as the banking institutions, fund managers, the JSE, and other lenders who are providers of financing to SOEs in South Africa (R1, R3, R4, R8, R9). The KAM disclosures provided them with insights that they could use for their own risk assessments and lending decisions, as it provided them with insights into the quality of the financial statements of the SOE, and related line items of interest, such as the quality of assets. The above indicated that the disclosure of KAMs for SOEs were mostly beneficial to participants in the financial markets, as such users already possessed the technical resources to meaningfully assess and draw conclusions from the information reported (R8).

> *R4: It gives them an opportunity to, sort of, zone in into [what are] those big areas, if I can put it that way, and those areas that could potentially be misstated, because, I mean, if you're applying judgements and assumptions and if you using certain experts, as well, there's always the potential for those things to be misstated, rather than applying a normal or [just accounting for] an ordinary transaction where you just purchase goods or services.*

R1, further, shared an example, demonstrating how the information included in the KAM section of the audit report was beneficial to participants in the financial markets.

> *R1: Just as a way of example of that is, when we, for instance, look at the specific development loans that the [ABC] issues, as part of [ABC]'s processes of doing the due diligence, evaluating the credit risk of the other state entities that the [ABC] lends to, they also use our audit reports to influence the risk rating they assign to these loans, and that's why it's so important for the key audit matters to also be on those reports, because they can then see where [is] the risks in the entity [are] and where the audit focus was placed, also for their own risk assessment processes. So, I really think it's a very important part of the audit report process.*

The above indicated that, to the providers of capital, the complexity and technical nature of KAMs were less of an obstacle, as they were well acquainted with the technical nature of the financial statements and KAMs, and had the necessary technical capabilities to meaningfully engage with it.

> *R9: ISA 701 financial reporting risks [are] being identified timeously by Parliament to enable them to intervene appropriately and hold management accountable…*

Although members of parliament might not be able to fully understand the KAMS, some respondents also indicated that KAMs provided an ideal platform to thoroughly engage on critical financial risks, that positioned them to question management on financial controls (R4, R7, R8). The lack of KAM engagements with parliamentary oversight committees previously signified that auditors had to restrict themselves to discussing the audit opinion, *sans* any detail concerning the risks and the procedures. KAMs have improved governance, by empowering parliamentary committees to question the audit process that informed the opinion (R4, R6, R8). When the auditor can use less technical terms, so as to successfully report, during their engagements with the users, on KAMs that require intervention, such as improvements in internal controls, this will enable such users to better understand the KAMs and, potentially, empower them with insights, in order to hold the management of SOEs accountable.

There are existing artifacts that guide the reporting of KAMs in the public sector in South Africa, that is currently restricted to entities with listed instruments on the JSE, as it meets the definition of a listed entity, as per ISA 701. Other SOEs, that do not have listed instruments, currently do not report KAMs in its audit reports. Respondents provided their views concerning the current scope of KAMs in the public sector, and expressed that there was a need to extend the scope of KAMs to all SOEs with significant debt, to enable debt providers to make informed decisions (R1, R2, R3, R4, R7, R9, R10). Respondents were of the view that the associated benefits that resulted from the reporting of KAMs, could be worthwhile for SOEs without listed instruments, as banking institutions still rendered significant debt advances to SOEs that do not have listed debt instruments. These banks needed to know that key financial risks, that impact its decision-making process, had been carefully considered by the auditors. The enhanced transparency created by KAMs was even more important within a public sector context, as SOEs were looking into less reliance on government funding and considering more debt- or equity providers of funding.

Respondents also indicated that, with the increased need for more credible non-financial sustainability information, that debt- and equity providers were increasingly relying on in decision-making, there was a need to consider wider reporting of KAMs in the public sector in South Africa, and the possibility of reporting KAMs related to non-financial reporting audit matters, should also be considered. R10 indicated that the primary users of the audit report in the public sector of South Africa, have a greater interest in the performance information of the SOE, considering its mandate. Although such financial and non-financial performance information were required by legislation in South Africa, to be audited by the AGSA, the scope of ISA 701 was restricted to financial statement matters only, and did not extend to the audit of information included in the annual performance reports of the SOEs.

The audit of this non-financial information, in most instances, would include considerations that were similar to what the auditor considered when identifying and reporting KAMs for financial statements. Respondents referred to the fact that often, management applied significant judgements in the preparation of such performance reports and, at times, auditors found that they are required to make use of experts to audit the non-financial performance information, owing to the complexity involved in its measurement and reporting. Information concerning the auditors' measures to satisfy themselves that the content of reports regarding such information was free from material misstatement, could be useful in providing additional transparency and comfort to the users of the audit report in the public sector.

Debt- and equity providers have started to incorporate non-financial sustainability information in their risk assessments, prior to making financing decisions. This suggested that there might be a need for auditing standard-regulators to start considering the incorporation of KAMs-reporting in assurance engagement concerning non-financial information, such as those executed in accordance with ISAE 3000 (Revised). The current increase in engagements and developments concerning the reporting of non-financial information and the need to audit such reports, further supported that.

4.2 Identify areas of key corporate governance weaknesses

Management and those charged with governance, were part of the discussions of and debates on KAMs. The auditor knew that if the matter was proposed as a key audit matter, management would have increasingly focused on it, resulting in improvement in financial controls and good governance (R7, R9).

Respondents agreed that one major value-add, stemming from the reporting of KAMs, was that KAMs provided enhanced insights into the critical areas of the audit, enabling management and those charged with governance to take further action, where required (R2, R3, R4, R6, R7, R8, R10).

4.2.1 Improves the focus on key financial reporting controls

The traditional focus of audit reports has often been centred on the audit opinion, alone (R2, R4, R6, R7, R8). Owing to the deteriorating state of affairs at South African SOEs, and the poor internal control environment—reportedly re-emphasised by the office of the AGSA— participants recognised that KAMs have a positive effect on encouraging a focused and continued discussions on the internal financial controls of SOEs. Such discussion have the potential to inspire improvement of financial controls (R2, R4, R6, R7, R8).

The inclusion of KAMs has shifted the focus from audit outcomes only to, now, also addressing deficiencies in financial reporting controls, and ensuring the production of sustainable, clean financial records. Respondents emphasised that KAMs played a significant role in identifying accounting matters that might not have been adequately recorded. According to R7, the communication of these matters in the auditor's report acted as a "wake-up call" for the management of SOEs, so that they can take measures

to address gaps in their financial reporting controls. By directing attention to such issues, KAMs prompted corrective actions that contributed to a more disciplined and reliable financial reporting process.

Respondents also highlighted that the inclusion of KAMs in the auditor's report has motivated management to examine their internal controls more critically. R6 noted that KAMs provided management with an opportunity to identify areas where controls can be strengthened, and information collection processes improved. R7 highlighted that KAMs encouraged auditors and management to collaborate in assessing internal controls and driving improvements, ultimately resulting in more accurate financial statements, over the long term. R6 and R7 remarked on the impact of KAMs on internal controls.

> *R6: KAMs allow even management the opportunity, maybe, to sort of see if they can improve in their controls or how they collect the information that they report.*

> *R7: KAMs help shift the focus from just addressing audit outcomes, to identifying and addressing areas where internal control improvements are needed to achieve sustainable, clean financial records.*

Respondents emphasised that an important step in building a frame for a KAM was to identify areas of key financial control weaknesses. This proactive approach enabled organisations to address potential control weaknesses and mitigate risks, leading to enhanced financial reporting reliability. Additionally, KAMs helped identify and highlight accounting matters where, although there were no modifications identified, auditors had to exert considerable time and effort in dealing with those matters, on account of management not having adequate internal controls and basic recordkeeping processes in place, prompting actions to enhance the internal control environment, thus encouraging improvements in internal controls.

4.2.2 Enhances audit committee engagement and actions

The disclosure of KAMs has proven to be of significant value to audit committees in fulfilling its oversight responsibilities. From the perspective of audit committee oversight, reporting KAMs added value in numerous ways. Primarily, it allowed audit committees to focus its attention on specific, critical areas of the audit process, providing it with an additional layer of assurance regarding the accuracy and legitimacy of management's actions, as reported in the annual financial statements (R1, R3, R4, R5, R6, R7). This view was further articulated by R4, who believed that the inclusion of KAMs in the audit report provided a means for the audit committee to gain reassurance that management's actions were not only correct, but also validated externally, through the audit process.

> *R4: From an audit committee oversight point of view, reporting KAMs provides value, because it allows [them] an opportunity to zone in and gain additional comfort that whatever management is doing is correct and is supported from an external audit point of view.*

Furthermore, KAMs empowered audit committees by providing it with a sense of comfort that it has exercised its oversight mandate diligently, by focusing its attention on the critical areas in the financial statements, during its engagements with management and the external auditors (R3). This was attributed to the matters reported as KAMs usually being a continuation of the matters that the audit committee would have discussed with management, prior to approving the annual financial statements, and it would be matters that the external auditor would have discussed with the committee, throughout the audit process. The identification and reporting of KAMs, therefore, served as a frame of reference that enabled audit committees to assess the effectiveness of the execution of its responsibilities, in line with the requirements of the Companies Act 71 of 2008 (RSA 2008), the PFMA (RSA 1999), and other corporate governance requirements applicable to the SOEs, as well as the audit process.

R5 and R6 further emphasised that KAMs impacted the audit committee's engagements. The suggestions concerning a KAM provided a foundation for meaningful discussions between the audit committee, the external auditors, and the management of SOEs. Reporting of KAMs allowed the audit committee to focus its time on following up on the results of the auditor's performance. This provided for a more structured engagement process, where the committee could assess the adequacy of completed audit procedures, and investigate whether all, identified, critical areas have been satisfactorily addressed.

> *R5: I think, from the audit committee's side, because we engage with them more, they normally do have, maybe not specifically on KAMs, but they normally want to know how specific matters have been addressed in the audit process. So that their users gain comfort over their ability to oversee the audit process and significant risks, because of this everyone wins, really.*

This also highlighted the knock-on effect KAMs could have on issues, such as public trust in the corporate governance processes. It further resulted in opportunities for KAMs to be used as tools for auditors in the public sector, to bring all their key stakeholders not only into their world, but also that of the client's processes, through the increased transparency of the audit and governance processes. R4 and R5 noted that members of management and audit committees were often close to the external audit process and were already included in the audit process, on account of the meetings between themselves and the external auditors. KAMs allowed for other stakeholders, such as parliamentary committee members and debt providers, to understand key financial risk matters that are being discussed in the boardroom.

R4 also stated that management and the audit committee were forced to deliberate more and familiarise themselves with the matters reported as KAMs, in the audit report. As a consequence, when the auditors considered presenting a matter as a KAM, they must be strategic in selecting a matter to which they want to draw more attention and interest, as both management and the audit committee would need to conduct ongoing discussions on it.

5 CONCLUSION

This study found that the implications of KAMs have forced auditors to improve their stakeholder engagement strategies, commencing with understanding key stakeholders, who hold power, legitimacy and urgency. Audit reports and, specifically, KAM reporting have been evinced as important tools for stakeholder engagement, and transparency towards key stakeholders. From this perspective, members of parliament and capital market participants were identified as key stakeholders of SOEs, and particular communication strategies have to be employed that respond to the information-needs, and will encourage actions on information received. Communication must be conducted in a manner that improves key stakeholders' understanding of financial risks, controls, and auditors' responses. Improved stakeholder engagement strategies have resulted in governance concerns or financial reporting risks being better understood, timeously, by Parliament, to enable it to intervene appropriately and hold management accountable. Although more still needed to be done by auditors in this regard, opportunities did exist.

This study found that public sector auditors were of the view that the inclusion of KAMs in the auditor's report proved to be a valuable tool in promoting oversight, transparency, accountability, and reliability in financial reporting, and provided information that was valuable to the management of SOEs and audit committees. This suggested that, when used effectively, the disclosure of KAMs could enhance the effectiveness of both management and the audit committees in the public sector. These views are contrary to the findings by Segal (2019), that KAMs do not add value for corporate governance structures. Auditors use KAMs to enable management to identify opportunities for improvements in internal financial controls, and may strengthen the execution of the mandates of those charged with governance, such as audit committees. This research entailed a detailed reflection and analysis of how KAMs assist those charged with governance exercise better oversight of critical financial matters. The disclosure of KAMs also enhances the effectiveness of the audit committees' execution of its mandates and provides it with additional reassurance that the auditors have focused on the relevant issues throughout the year and during their reviews of the annual financial statements. Overall, the study has demonstrated that, when used effectively, the disclosure of KAMs can play a pivotal role in enhancing and strengthening the governance and accountability processes at SOEs.

KAMs were identified as having the potential to inspire change in the oversight behaviour of politicians—when parliamentary oversight committee members obtain an understanding of key financial risk areas in SOEs, they are empowered with regard to areas of investigation and focus. When politicians understand this power of KAMs, they will be in a better position to use them as starting points for questioning and assessing the return, on investments made by the government in SOEs. This requires that auditors employ less technical language in explaining key audit matters and frame it in a manner that responds to the information-needs of portfolio committee members. There is a need for future studies that will unpack why parliament does not receive urgent or serious attention from SOEs regarding financial management reporting matters, as the current study did not explore this, in detail.

This study contributes to stakeholder theory *via* its identification of the various users of the audit reports of SOEs, in South Africa. The study further recognised that these groups of users have different information-needs, and these are affected by their level of understanding of basic auditing and accounting, contributing to the theoretical debate on the relevance of audit information to various stakeholders. The study found that, in relation to SOEs, the information-needs of key stakeholders were shifting to more non-financial, forward-looking information, that rendered it necessary for auditors to acknowledge this and provide assurance and KAMs concerning such information, in the near future, in order to protect the information-usefulness of audit reports. The study further contributes to the theory of accountability by demonstrating that the effective use of KAMs may result in strengthened governance and accountability processes in the public sector.

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