

Relevance of Governance Value with Disclosure of Key Audit Matters (KAM) as Mediation

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Abstract

Introduction/Main Objectives: This study aims to examine the effectiveness of corporate governance in enhancing financial reporting quality and its subsequent impact on investor decision-making. Specifically, it investigates the role of the audit committee's expertise and meeting frequency in governance, using Key Audit Matters (KAM) disclosures as a measure of financial reporting quality, while stock prices reflect investor responses. **Background Problems:** Corporate governance plays a crucial role in ensuring transparency and reliability in financial reporting. However, the extent to which governance mechanisms, such as audit committee characteristics, influence financial reporting quality and investor perceptions remains unclear. Additionally, while KAM disclosures are intended to reduce information asymmetry, their impact on investor decisions may vary depending on how they are interpreted. **Novelty:** This study introduces KAM as a mediating variable, linking corporate governance to investor decision-making. It also explores the dual effect of KAM disclosures—while they signify strong governance and transparency, they may also signal heightened risks, potentially leading to mixed investor reactions. **Research Methods:** The study employs Ordinary Least Squares (OLS) regression analysis on a dataset comprising 253 observations from 2022. Governance is measured by the audit committee's expertise and meeting frequency, financial reporting quality by KAM disclosures, and investor decisions by stock prices. **Finding/Results:** The results indicate that the audit committee's expertise significantly influences stock prices, with KAM acting as a competitive moderating variable. A highly skilled audit committee leads to more detailed KAM disclosures, reflecting strong governance. However, increased KAM disclosures may also be perceived by investors as indicators of potential risks, affecting stock prices negatively despite the underlying transparency. **Conclusion:** While robust corporate governance improves financial reporting quality through thorough KAM disclosures, the market's interpretation of these disclosures can be complex. Investors may associate higher KAM disclosures with elevated risks, even when they stem from strong governance practices. This highlights the need for clearer communication in audit reporting to align transparency with investor confidence.

Keywords: Audit Committee; Corporate Governance; Financial Reporting Quality; Investor Decision Making; Key Audit Matters (KAM)

JEL Classification: M41; M42

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INTRODUCTION

Key Audit Matter (KAM) are matters that in the auditor's professional judgment are the most significant areas in the audited financial statements in the current period (IAASB, 2015). KAM was initiated by the International Auditing and Assurance Standard Board (IAASB) as an international auditing standard setting board, which aims to increase the transparency of audited financial statements. The IAASB states that the purpose of KAM disclosure is to enhance the communicative value of the auditor's report for users. This is achieved by providing greater transparency about the audit that has been performed. The communicative value of the auditor's report will be achieved when the auditor's report can provide clearer information for users. Thus, it can minimize the information gap, which is the difference between users' expectations of what should be available to assist them in making investment and fiduciary decisions and what is actually available to them through the entity's audited financial statements.

The role of governance consisting of the board of directors and the board of commissioners in the company as a business entity is to set policies, provide direction, and monitor the company's performance to maximize value for shareholders and other stakeholders. The board of commissioners is the pinnacle of internal corporate governance and plays a critical role in overseeing business operations and management (Dang and Nguyen, 2022; Nguyen, 2022). The board of commissioners has an effective role in limiting the opportunistic behavior of managers, reducing agency problems, and increasing the demand for company shares. An effective board of commissioners can help the company manage its contractual relationships with customers and suppliers more efficiently, thereby increasing the trust of external parties, such as creditors or lenders. This will reduce operating costs through reduced borrowing costs or interest that must be paid by the company (Piot and Missonier-Piera, 2009). Companies with effective board members are more valued by investors and are expected to attract more investment. Previous research shows that the board of commissioners is able to influence investors' investment decisions (Amer Al-Jaifi et al., 2017; Shin and Kim, 2018).

From an accounting and finance perspective, the board is responsible for the integrity and accuracy of the company's financial reporting, including the implementation of effective internal controls and the appointment of external auditors (Tugman and Leka, 5AD). Agency theory says that companies with good governance mechanisms will have low agency problems (Fama and Jensen, 1983). The existence of an audit report will reduce agency problems and information asymmetry between management and shareholders. Effective corporate governance mechanisms and more detailed auditor reports will deter managers from acting opportunistically at the expense of shareholder interests (Jensen and Meckling, 2019). Effective corporate governance mechanisms will protect shareholders' interests by monitoring the company's activities and aligning the interests of management and shareholders. The framework for determining KAM starts from matters communicated to directors and commissioners, or often referred to as those charged with governance (TCWG). The supervisory function performed by the board of commissioners is expected to influence the disclosure of KAM, because the external auditor communicates with the board of commissioners regarding matters affecting the company's financial activities and financial audits.



Corporate governance is a structure and process used to direct and manage the business to achieve business progress and corporate accountability with the ultimate goal of creating corporate value and shareholder wealth in a sustainable manner with due regard to the interests of stakeholders. Essentially, corporate governance encompasses the rights and responsibilities and relationships among the corporation's stakeholders. Corporate governance not only concerns the interests of shareholders but also maintains a balance with the needs of other stakeholders such as lenders, employees, customers, suppliers, authorities, the general public, the communities in which the corporation conducts its business. This research uses the term governance, not governance, because the phrase governance in corporations focuses more on the internal management of the corporation, while governance relates to broader stakeholders, including the rights of shareholders and other parties that are outside the scope of management of the Board of Directors.

This research is important because Auditing Standard (SA) 701 on Communicating Key Audit Matters (KAM) has the potential to reduce the information gap for report users. The decrease in the information gap is due to the increase in information disclosed in the independent auditor's report that was previously unavailable (Yoga and Dinarjito, 2021).

To improve the quality of the auditor's report to be more informative, in 2021, the Indonesian Institute of Certified Public Accountants has established a new Auditing Standard (SA), namely SA 701 concerning Key Audit Matters (KAM) in the Independent Auditor's Report. SA 701 relates to the auditor's responsibility to communicate key audit matters with those charged with governance (TCWG) and communicate them in the auditor's report. SA 701 is effective for audits of financial statements for periods ending on or after January 1, 2022.

There is still very little research on KAM in Indonesia, considering that Auditing Standard 701 concerning Communication of Key Audit Matters (KAM) in the Independent Auditor's Report is still new. (Yoga and Dinarjito, 2021) conducted a literature review to see the readiness of SA 701 implementation in Indonesia. The result of this study is that the disclosure of Key Audit Matters (KAM) increases the communicative value of the auditor's report which is useful for users of financial statements as a consideration in decision making.

Good governance is the combination and policy of the elements of the Board of Commissioners structure to effectively resolve agency conflicts and reduce information asymmetry. Good corporate governance will provide more transparent and reliable information. The information disclosed by the company will help improve the accuracy of investor forecasts. Research by (Herawaty and Solihah, 2019) shows that the implementation of good corporate governance allows companies to reduce income manipulation which is often a motivation for management.

The existence of members of the Board of Commissioners is expected to create better governance. This signals to the capital market that the company has conducted a good supervisory process, and this can have an impact on investors' perceptions of the company's value. Investors are interested in investing in companies with good governance practices and are willing to buy higher share prices because good governance limits managers in their selfish efforts (Lombardo and Pagano, 1999). Good governance also enhances a company's negotiating power when dealing with various stakeholders, thereby reducing the cost of enforcing contracts between them (Lombardo and Pagano, 1999). In addition, the Board of Commissioners also has a role in appointing independent auditors, evaluating the reasons

for management's choice of accounting policies, and assessing the quality of company management. A more transparent audit report, by disclosing key audit matters, is expected to reduce agency costs and information asymmetry in financial reporting.

Companies with board members who are competent in finance are able to present higher quality financial reports and reduce the restatement of financial statements (Agrawal and Chadha, 2005). Members of the board of commissioners who have financial expertise are able to understand and solve problems raised by auditors in preparing financial statements. In addition to financial literacy, diverse knowledge and educational backgrounds are essential to accelerate strategic decision-making (Katmon et al., 2019). The diversity of these competencies is expected to provide better supervision of company management and improve company performance. Apart from the competence of the board of commissioners, the frequency of meetings also affects the quality of financial statements. The more frequent the frequency of meetings of members of the board of commissioners, it will reduce the possibility of fraud by allowing directors and commissioners to identify and resolve potential problems, especially those related to the quality of financial reporting (Chen et al., 2006).

Agency theory supports the role of KAM as an information environment that reduces agency problems (Goh et al., 2016). KAM disclosure is the result of negotiations and discussions between the board of commissioners and the external auditor. KAM disclosure provides information to investors regarding audit issues faced by the company, so it is expected to reduce information asymmetry and can influence investor reactions. According to signaling theory, the attributes of board members provide signals to investors that help them to distinguish between good and bad companies (Ittonen, 2012). By helping investors distinguish between these two types of companies, KAM disclosures allow them to make better investment decisions. The efficient market hypothesis states that in a semi-strong market like Indonesia, stock prices always incorporate all available information, such as auditor reports, annual earnings, dividends, stock splits, and so on.

KAM disclosure is the result of discussions and negotiations between auditors and TCWG. This study predicts that board attributes influence KAM disclosure. This study predicts a relationship between board attributes and investors' share price, as well as a relationship between board attributes and KAM disclosure. There is thus a chain of relationships between these three variables, with KAM disclosure as the mediator in this relationship. This is consistent with recent empirical evidence showing that the board directly and indirectly affects share price (Goh et al., 2016).

This study proposes that corporate governance mechanisms have an indirect effect on investor reactions through KAM disclosure. Good corporate governance mechanisms are expected to reduce information asymmetry through KAM disclosure, so that investors react. The combination of agency theory and signaling theory provides a prediction of the mediating role of KAM disclosure between board attributes and investor reaction. Therefore, this study proposes the following hypothesis:

H1: There is an effect of the attributes of the board of commissioners on the share price.

H2: KAM disclosure mediates the relationship between the attributes of the board of commissioners with stock price.



RESEARCH METHOD

The population in this study were all companies listed on the Indonesia Stock Exchange (IDX) in 2022-2023. The sampling technique used in this study was purposive sampling. The sample criteria in this study are (1) nonstate-owned companies; (2) other than the financial and banking industries. The data in this study consist of (1) audit committee data obtained from the annual report of each sample company in the observed year; (2) audited financial statement data obtained from each financial sample company.

The variables in this study consist of dependent variables, independent variables, control variables and mediating variables. The dependent variable in this study is the company's stock price (*PRICE*), measured by the stock price three months after the date of the financial statements. The independent variable in this study is corporate governance as measured by the competence of audit committee members (*KKA*) and the number of audit committee member meetings (*RKA*). The control variables in this study consist of netprofit (*NETPROFIT*), company size (*SIZE*), profitability (*ROA*), and leverage (*LEV*). *BVS* and *EPS* are two significant variables that affect stock prices (Ohlson, 2001). *SIZE* is also a significant determinant of stock price (Habib and Azim, 2008; Lopes and Reis, 2019; Sharif et al., 2015). In this context, larger firms are more likely to be profitable. Meanwhile, *LEV* is an important determinant of stock prices as investors place more value on firms with low debt, as low interest payments allow these firms to maximize stakeholder returns (Habib and Azim, 2008; Sharif et al., 2015).

The mediating variable in this study is the number of KAMs disclosures. The number of KAMs indicates managerial opportunism and corporate risk, which may influence investors to change their investment decisions (Lin et al., 2020). The number of KAM can also affect users' perceptions of the reliability of audited financial statements. These entity-specific risk disclosures are more attractive to investors than general account-level risk disclosures (Gold et al., 2020).

To test H1, this study uses multiple regression analysis to determine the relationship between the dependent variable and the independent variable. The regression model is as follows:

$$PRICE_{it} = \beta_0 + \beta_1 KKA_{it} + \beta_2 RKA_{it} + \beta_3 NETPROFIT_{it} + \beta_4 SIZE_{it} + \beta_5 ROA_{it} + \beta_6 LEV_{it} + \varepsilon_{it}$$

(1)

This study uses the approach of (Baron and Kenny, 1986) and (Zhao et al., 2010) to test the mediating role of KAM disclosure. According to (Baron and Kenny, 1986), three conditions must exist to test the mediation effect. First, there is a significant total effect of the independent variable (X) on the dependent variable (Y) without the influence of the mediator variable (M). Second, there is a significant direct effect of the independent variable (X) and the mediator variable (M). Lastly, there is a significant direct effect of the independent variable (X) on the dependent variable (Y) when controlling for the mediator variable (M).

$$PRICE_{it} = \beta_0 + \beta_1 KKA_{it} + \beta_2 RKA_{it} + \beta_3 NETPROFIT_{it} + \beta_4 SIZE_{it} + \beta_5 ROA_{it} + \beta_6 LEV_{it} + \varepsilon_{it}$$

(2)

$$KAMSCORE_{it} = \beta_0 + \beta_1 KKA_{it} + \beta_2 RKA_{it} + \beta_3 NETPROFIT_{it} + \beta_4 SIZE_{it} + \beta_5 ROA_{it} + \beta_6 LEV_{it} + \varepsilon_{it}$$

(3)

$$PRICE_{it} = \beta_0 + \beta_1 KKA_{it} + \beta_2 RKA_{it} + \beta_4 KAMSCORE_{it} + \beta_3 NETPROFIT_{it} + \beta_4 SIZE_{it} + \beta_5 ROA_{it} + \beta_6 LEV_{it} + \varepsilon_{it}$$

(4)

The first step in this study is supported if the regression coefficients β_1 or β_2 , in the regression equation (1) are significant. The second step in this study tested the mediating variable, *KAMSCORE*. Indirect influence describes the path from the independent variable (X) to the dependent variable (Y) through the mediator (M). Determination as a mediating variable is done in the following way: A mediating variable is referred to as complementary mediation if the direct and indirect effects of the independent variable on the dependent variable are significant and have the same direction. A mediating variable is called competitive mediation if the direct and indirect effects of the independent variable on the dependent variable are significant, but have the opposite direction. This mediation is not considered in the Baron and Kenny method because if the direct and indirect effects are significant but point in the opposite direction, then the total effect may approach zero, causing the independent-dependent variable test to fail.

RESULTS AND DISCUSSION

The number of observations processed in this study is 626 company, with details shown in Table 1, Panel A. Panel B presents the industry distribution of the sample. The highest number of KAMs are reported for the Consumer Cyclical sector (19 percent), followed by the Consumer non-Cyclical sector (15.89 percent), the basic materials sectors (12.66 percent) and then the energy sectors (10.04 percent).

Table 1. Sample distribution

Panel A: Sample selection procedure	
Description	Total
Number of companies listed on the IDX in 2022	626
Less number of companies that do not disclose key audit matters in the auditor's report	40
Less number of companies for which data is not available	233
Final observations	253

Source: data processed

The data were processed using version 29 of the SPSS statistical software. The data were initially analyzed using descriptive statistics to determine the mean and standard deviation of each variable in this study. Finally, multiple regression analysis was conducted to examine the positive relationship between auditor reputation and KAM disclosure. The results of descriptive statistics analysis are shown in Table 2.



Tabel 2. Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
<i>PRICE (Rp)</i>	253	22.000	37900.000	1320.636	4466.989
<i>KAMSCORE</i>	253	1.000	6.000	1.355	0.662
<i>NETPROFIT</i>	253	0.000	1.000	0.320	0.467
<i>SIZE</i>	253	24.573	32.660	27.953	1.627
<i>LEV</i>	253	-13.644	41.479	1.089	3.629
<i>ROA</i>	253	-0.409	0.469	0.026	0.094
<i>KKA</i>	253	1.000	4.000	2.311	0.738
<i>RKA</i>	253	1.000	54.000	5.220	4.444

Source: data processed

According to the audit report, the auditor disclosed the number of KAMs in the year of adoption, which ranged from one to a maximum of six, with an average value of 1.35. This figure is nearly identical to that found in study by Boonlert-U-Thai and Suttipun (2023) (mean = 1.9578), and significantly lower than that found in studies by Bepari et al. (2022) (mean = 2.763) and Rahaman et al. (2023) (mean = 3.54).

This research includes two hypotheses. The first hypothesis examines the impact of audit committee attributes on stock price. The attributes assessed are the expertise of the audit committee and the frequency of audit committee meetings. The findings from hypothesis testing 1 are shown in Table 3, Panel A. The results indicate that the audit committee's expertise has a significant influence (with a significance level of 0.02) on stock price. Additionally, the control variables that significantly affect stock price are company profit (significance level of 0.000), company size (significance level of 0.000), and return on assets (significance level of 0.000). A highly skilled and experienced audit committee is capable of effectively overseeing the company's financial and operational processes. They can better interpret and evaluate financial statements, detect potential issues or discrepancies, and ensure the accuracy of accounting and reporting procedures. Such thorough oversight reduces the risk of errors or financial manipulation, helping to create a positive perception among investors and, consequently, influencing the stock price.

Tabel 3. Panel A. Step 1 (Dependent variable: *PRICE*)

Variable	Coefficient	T	Sig.
NETPROFIT	-.252	-5.152	.000
SIZE	.614	11.644	.000
LEV	-.016	-.329	.743
ROA	-.182	-3.604	.000
KKA	.152	3.162	.002
RKA	-.040	-.822	.412

Source: data processed

Next stage shown in Table 3 Panel B. The second step in this study tested the mediating variable, *KAMSCORE*.

Tabel 3. Panel B. Step 2 (Dependent variable: *KAMSCORE*)

Variable	Coefficient	t	Sig.
NETPROFIT	.483	8.823	.000
SIZE	.200	3.399	.001
LEV	-.187	-3.490	.001
ROA	-.216	-3.834	.000
KKA	-.110	-2.062	.040
RKA	.260	4.831	.000

Source: data processed

Tabel 3. Panel C. Step 3 (Dependent variable: *PRICE*)

Variable	Coefficient	t	Sig.
NETPROFIT	-.258	-5.188	.000
SIZE	.611	11.543	.000
LEV	-.013	-.277	.782
ROA	-.179	-3.531	.001
KKA	.153	3.182	.002
RKA	-.043	-.886	.376
KAMSCORE	.035	.721	.472

Source: data processed

Hypothesis 2 testing indicates that KAM disclosure mediates the relationship between audit committee attributes and stock price. Based on the data analysis in Table 3, Panel B and Panel C, it shows that the audit committee's expertise directly influences KAM disclosure with a significance value of 0.040 (less than 0.05) with a negative direction of influence. In Table 3, Panel 3, it shows that the audit committee's expertise affects the stock price with a significance value of 0.02 (less than 0.05) with a positive direction of influence. According to Baron and Kenny (1986), KAM serves as a competitive mediation variable. An audit committee with strong expertise prompts auditors to provide more detailed and thorough KAM disclosures. Although this reflects high governance standards, such in-depth disclosures can also highlight significant risks. As a result, investors may interpret an increase in KAMs as a sign of potential issues, even though it represents the audit committee's commitment to transparency (Suttipun, 2020).

Audit committee expertise is anticipated to improve the quality of oversight and financial reporting, potentially boosting the stock price. However, a large number of disclosed KAMs might cause investor caution, as a higher count is frequently linked to increased risk. In this context, KAM acts as a competitive mediation variable, as it simultaneously provides positive signals about oversight quality while also sparking concerns over possible risks. Extensive KAM disclosure is seen as an indicator of strong transparency and accountability by the company, which could positively influence the stock price. However, a high level of KAM disclosure may also expose notable risks or uncertainties in the financial statements, possibly reducing investor interest and negatively impacting the stock price (Liao *et al.*, 2023). Given that KAM disclosures provide crucial information, a higher number of them can lead to uncertainty in investors' evaluations. While some investors see the increase in KAMs as a sign of a competent and transparent audit committee, others view it as a signal of increased complexity and risk in the company's



operations. This uncertainty results in a competitive mediation, where the influence of the audit committee's expertise on the stock price becomes more complex and potentially contradictory.

CONCLUSION

This study examines the disclosure of Key Audit Matters (KAM) as a mediator in the relationship between the attributes of the audit committee and stock price. The study uses KAM as a mediation variable in the relationship between the audit committee and stock price because KAM provides valuable insights into transparency and risk management processes that influence investor perception of a company.

The research emphasizes that strong corporate governance plays a crucial role in shaping investor reactions. These governance mechanisms, which include effective oversight by the audit committee, help reduce uncertainties or information asymmetry about the company's financial health. Effective corporate governance reduces information asymmetry, where one party (company management) has more information than the other (investors). Strong corporate governance enables investors to access accurate, reliable, and timely information, which in turn facilitates better investment decision-making.

The findings of the study show that the disclosure of Key Audit Matters (KAM) plays a key mediating role in the relationship between corporate governance attributes and stock price. KAM refers to significant issues identified by auditors that must be disclosed in financial reports. The disclosure of KAM provides transparency regarding potential risks, allowing investors to better assess the company's financial situation. This transparency helps investors react more confidently to the company's stock, which in turn affects the stock price.

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