

The Benefit of Adding Key Audit Matters to the Auditing Report

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Abstract—On December 23rd, 2016, the Ministry of Finance issued a new audit guideline "No. 1504 Auditing Standards for Chinese Certified Public Accountants - Communicating Key Audit Matters in Auditing Report." Based on the audit report of 84 A+ H-share listed companies in 2016, we investigated the cost and benefit of new key audit matters. The results we obtained demonstrate that the disclosure of additional information by Chinese auditors has very limited effects, comparing with the content and form of the key audit matters of foreign countries. Our empirical results do not support the idea that the disclosure of key audit matters brings significant benefits. Our findings indicate that the disclosure of additional information by the auditors rather has a symbolic value than an informative value. However, our studies allow enriching the current international debate on the introduction of key audit matters.

Keywords—*key audit matters; benefit; audit quality; market reaction*

I. INTRODUCTION

In order to meet the capital market demand for high-quality accounting information and improve the quality of audit reports of listed companies, the Ministry of Finance released a new audit standard on December 23rd, 2016-"No. 1504 Auditing Standards for Chinese Certified Public Accountants - Communicating Key Audit Matters in Auditing Report." The new auditing standard requires the A+H share companies to implement the new standard to their financial reporting audit from January 1st, 2017. These companies took the lead in implementing the new standard. So how to disclose the key audit matters in Chinese audit reports, and how to balance the benefits and costs brought about by the disclosure of key audit matters, are the focuses of this article.

Influenced by the audit failure of enterprises in various countries since the early 21st century and the financial crisis in 2008, the international calls for improving the audit quality and improving the information content of audit reports have been on the rise.

Regulators have begun the regulatory reform process in this area. From 2014 European Union pointed that audit report on financial reporting should specify the most significant risks of material misstatements and the CPA's measures [7]. The International Auditing and Assurance Standards Board (IAASB, 2013) and the Public Company Accounting Oversight Board (PCAOB, 2013) recently proposed new auditing standards for

public companies that require auditors to disclose specific audits of key auditing matters in their audit reports (Key Audit Matters, KAM). These changes in the audit report are aimed to reduce information asymmetry - the gap between the information the investors want to obtain from the audit report and the disclosure of the company and the audit report [4].

However, there is no evidence that requiring auditors to add additional information will increase the value of the audit report information and reduce the information asymmetry that exists between management and investors. Practitioners and academics challenge the addition of key audit matters to audit report, and they doubt that KAMs may become models over time (IAASB, 2012a). Due to reliability issues, auditors may report key issues as few as possible or provide lengthy disclosures (IAASB, 2012a). At the same time, the key issue segment uses accounting professional language, so the users of audit reports may find it is hard to understand as a non-accounting professional [3]. As a result, the disclosure of key audit matters may result in excessive amounts of other reporting content, obscure audit reports, additional costs and uncertainties (IAASB, 2012a).

The remainder of this article is organized as follows. The second part introduces the content of the key audit matters segment guidelines and the specific analysis of the disclosure in 2017. The third part analyzes the expected costs and benefits of disclosing the key audit matters and makes assumptions. The fourth part builds the hypothesis model. The fifth part, carry on the analysis and discuss the data result. The last section summarizes the results and draws conclusions.

II. NEW AUDITING STANDARDS AND EXECUTIVE ANALYSIS

A. Proposed key audit matters

In 2016, the Ministry of Finance issued 12 new auditing standards for financial reports. The only new one was "Auditing Standards for Chinese Certified Public Accountants - Communicating Key Audit Matters in Auditing Report", which is the core of this revised standard. Meanwhile, the enforcement of No.1504 conforms to the trend of the revision for the global auditing report standards [6].

"Key Audit Matter refers to the matter that certified public accountants consider to be the most important matter of the

current financial statements based on professional judgment, and the key auditing matters are selected from the matters communicated between certified public accountants and managers." (Certified Public Accountants Auditing Standards No. 1504 - Communicating key audit matters in the audit report).

According to NO.1504, to determine the key audit matters, matters should be considered from three aspects: First, to assess major areas of the greater risk of material misstatement or special risk; Second, involving major areas of management judgment; Third, major transactions or matters. The auditor needs to state in the audit report that why the matter is the key audit matter and how the matter should be handled during the audit work. We collected audit reports through CSMAR database and manual collection, as of June 10, 2017, and found that a total of 84 A + H shared listed company issued an audit report. In this paper, the audit reports of the key issues were summarized.

TABLE I. KAMS OF A+H SHARES LISTED COMPANIES IN 2016

Type	Key Audit Matter	Total
Revenue Recognition	Revenue Recognition-Accuracy	12
	Revenue Recognition-Cut-off	2
	Revenue Recognition- product sales and construction contracts	8
	Government subsidy	2
	Deferred income	2
Fair Value Measurements	Fair value of consumptive biological assets	2
	Valuation of financial instruments	12
	Confirmation of termination of financial assets	1
	Identifiable intangible assets	1
	Real estate investment	1
Impairment of Assets	Devaluation of fixed assets and construction projects	17
	Impairment of goodwill	17
	Impairment of financial assets	7
	Preparation for fixed assets impairment	7
	Preparation for bad debts of accounts receivable	16
	loss of loans and advances	10
	Allowance to reduce inventory to market	17
	Loss of contract loss	1
	Impairment of the intangible assets of the franchise	1
	Devaluation of intangible assets with uncertain life	3
Deferred Tax Assets	Impairment of investment	5
	Deferred income tax assets associated with a deductible loss	5
Tax	Deferred income tax	1
	Change from tax business tax value-added tax or land value-added tax	2
Related Party Transactions	sale business	2
Others		37

The major factors that affect the audit are mainly the revenue recognition, fair value recognition, assets impairment, deferred income tax, equity transaction and other accounting

matters. The disclosure of key audit matters has obvious features of industry concentration, such as financial industry generally focusing on the fair value of financial assets, impairment of financial assets, provision for loan and advances losses, and consolidation of structured entities. In addition, the auditors also proposed for their personality characteristics of key audit issues. For example, one of the key matters is litigation in BaiYunsan audit report, which is not disclosed in the other companies.

B. Disclosure of Key Audit Matters: Problems and Improvements

Through the analysis, we found that there are still some shortcomings for the disclosure of key audit matters in China. Firstly, the key audit matters are almost same. In particular, in some industries, only the data of matter is different. Second, the disclosure of information is redundant. For report users, an especially non-financial specialist, large sections of text is difficult to accurately understand.

The UK, which started the audit report reform early, has accumulated more than four years since 2012. The disclosure of key audit matters in UK is complete and reasonable [1]. By comparing with audit reports of public companies in the UK, I suggest that the standards for key auditing matters in China can make some improvements. First, use graphic form. Taking Roll Royce Holdings (PLC) as an example, in its annual audit report for 2015, KPMG, its audit firm, presented 18 key issues in the form of a scatter plot. Scatter plots can intuitively show the probability and impact of key audit issues. Through this form, users of audit reports can directly grasp the risk points and pay attention to their own concerns. Second, KPMG also provided a brief description of the audit work, detailing the contents of the audit work, such as asking, sampling of vouchers and so on. Chinese current guidelines did not require a clear indication of the details of the audit.

III. COSTS AND BENEFITS OF KEY AUDIT MATTERS

A. Key audit matters and market reaction

The economic consequences of key audit matters exist arguments. The first view is that when key audit matters are disclosed, the degree of information asymmetry between auditors and users of annual reports is reduced [9]. In this case, the key audit matter may be the appropriate solution to the needs of users. As long as key audit matters provide new information to users of annual reports, we may find that financial markets have responded to their disclosures. As a result, this paper proposes Hypothesis 1:

H1: Disclosure of key audit matters improve the market response compared to the company audit report that did not disclose key audit matters.

B. Key audit matters and audit quality

Disclosure of key audit matters can lead to higher audit quality. Disclosing some key audit issues may result in the auditors being held accountable for the key issues to be reported, and they will make further efforts to analyze these issues [8]. Some investors believe that the key audit matters

can have a positive impact. Sun Lixia [5] suggests that we can expect "the quality competition among auditing firms, especially in the area of professional suspicion, will increase the value of auditing to investors." In addition, the benefits of disclosing these key issues have contributed to the audit report. This is even more noticeable to users, which may increase auditor costs if these audited key matters go wrong. Thus, this paper proposes Hypothesis 2:

H2: The disclosure of key audit matters improves the quality of auditing compared with the auditing report of the company that has not disclosed the key audit matters.

IV. EMPIRICAL MODEL

A. Samples and data sources

The data used in this article, mainly from the CSMAR database and Rasset database. At the same time, propensity score matching method was used to produce a comparable control group. The number of A+H listed companies disclosing key audit matters is 84, while the number of comparable control group of A-share listed companies that did not disclose key audit matters is 154.

B. Empirical model

We examined two models to understand benefits of China A+H listed companies to disclose key audit matters: a model to evaluate their content (market reaction) and another model to assess the main characteristics of the audit: Quality (as measured by unexpected accrued profits). The KAM indicator variable is equal to 1 if the company's audit reports the key audit segment and 0 otherwise.

C. Market Response Analysis

The first model allows us to examine the reaction of financial markets when reporting the key auditing matters. Or to be more exact, we measure the cumulative abnormal return (CAR) around the announcement date.

$$|CAR| = \beta_0 + \beta_1 KAM + \beta_2 LN_MARKET_CAP + \beta_3 ILLING_DELAY + \beta_4 MB + \beta_5 DEBT + \beta_6 VAR_NI_TA + \beta_7 ROA + \beta_8 IFRS + \beta_9 CROSS_LIST + \text{firm fixed effects} + \text{year fixed effects} + \varepsilon \quad (1)$$

We use the absolute value of cumulative abnormal returns (|CAR|) to cover the declaration date and the day after the declaration. If the disclosure of key audit matters reduces the asymmetry of information, the key auditing matters will disclose a positive coefficient of KAM. We control the firm size (LN_MARKET_CAP), delay in filing the annual report (FILING_DELAY), market-to-book ratio (MB), leverage (DEBT), variation in net income (VAR_NI_TA), return on assets (ROA), whether the company uses International Financial Reporting (IFRS), whether the company is cross-listed in the United States (CROSS_LIST), and company and year fixed-effects.

D. Audit Quality Analysis

The second model in this paper can assess the impact of key audit matters on audit quality. In the previous studies, the

unexpected accruals were used as a measure of audit quality. We use the following model to examine the relationship between audit quality and audit of key matters.

$$|UNACC| = \alpha_0 + \alpha_1 KAM + \alpha_2 LOGASSETS + \alpha_3 DEBT + \alpha_4 ROA + \alpha_5 LOSS + \alpha_6 CROSS_LIST + \alpha_7 BIG4 + \text{firm fixed effects} + \text{year fixed effects} + \varepsilon \quad (2)$$

We use the absolute value of unexpected accruals (|UNACC|). These unexpected accruals are generated by the modified Jones model. If key audit matters have an impact on audit quality, we expect KAM to be negatively correlated with |UNACC|. We also control other variables such as LOGASSETS, DEBT, profitability (ROA and LOSS), and whether or not the Big Four audits (BIG4) based on previous findings [2].

V. EMPIRICAL RESULTS

A. Market Reaction

Table II (Panel A) shows descriptive statistics for test and dependent variables (|CAR|).

TABLE II. MARKET REACTION ASSOCIATED WITH KEY AUDIT MATTERS (KAMS)

Panel A Descriptive statistics for test variables					
Variable	Total Sample N=238	No KAM (KAM = 0) N=154	KAM (KAM = 1) N=84	t value	P
CAR	0.0156	0.0206	0.0145	4.71	<0.01

Panel B Regression results

Parameter	Model 1b(KAM Period) N=238			Model 1a(Sample Period) N=84		
	Coef.	Std. Err	P	Coef.	Std. Err	P
KAM	0.0088	0.0103	0.39			
FILING_DELAY	0.0000	0.0000	0.34	0.0000	0.0000	0.48
MTOB	0.0004	0.0004	0.36	-0.0004	0.0006	0.55
DEBT	0.0003	0.0006	0.59	0.0006	0.0007	0.45
VAR_NI_TA	-0.0025	0.0185	0.89	-0.0132	0.0193	0.49
ROA	0.0187	0.0213	0.38	0.0186	0.0237	0.43
IFRS	0.0084	0.0048	0.08	0.0064	0.0045	0.15
USA	0.0014	0.0027	0.61	0.0017	0.0030	0.57
Firm_Fixed Effects	incl.			incl.		
Year_Fixed Effects	Incl.			Incl.		
F-Value	2.27			2.130		
Adj R-Sq	0.255		<.01	0.283		

Contrary to expectations, univariate statistics show that the absolute CAR and KAM requirements are significantly lower. Panel B results show that the introduction of KAM has no significant effect on the financial markets. Therefore, we found no evidence that the value of the information provided in the Key Audit Matters section of the audit report was higher than the value of the other information and that there was no

evidence that the key audit matters would eliminate the information asymmetry.

B. Unanticipated Accrued Profit

Panel A in Table III shows descriptive statistics for the dependent variable ($|UNACC|$). Contrary to expectation, the unanticipated accrued profits during the period of the disclosure of the key audit matters were higher than the control group and this difference was significant.

Panel B in Table III shows that the disclosure of key audit matters does not affect the level of non-estimated accrued profits and therefore there is no evidence that the quality of financial reporting will be improved upon disclosure of key audit matters.

TABLE III. UNEXPECTED ACCRUALS ASSOCIATION WITH JUSTIFICATION OF ASSESSMENTS

Panel A Descriptive statistics for test variables					
	Total Sample	No KAM (KAM = 0)	KAM (KAM=1)	Test	
Variable	N=238	N=154	N=84	t value	P
$ UNACC $	0.0719	0.0469	0.0736	1.94	<.10

Panel B Regression results						
	Model 2b N=238			Model 2a N =84		
Variable	Coef.	Std. Err.	P	Coef.	Std. Err.	P
<i>KAM</i>	-0.0251	0.0453	0.58			
<i>LOG_ASSETS</i>	-0.0082	0.0569	0.70	-0.0124	0.0787	0.63
<i>DEBT</i>	-0.0396	0.0542	0.67	-0.0932	0.0729	0.38
<i>ROA</i>	-0.0313	0.0213	0.90	0.1558	0.0256	0.59
<i>LOSS</i>	0.0241	0.2614	0.37	0.0461	0.2921	0.13
<i>CROSS_LIST</i>	-0.0264	0.0934	0.45	-0.0215	0.1063	0.60
<i>BIG4</i>	-0.0755	0.0266	0.19	-0.0706	0.0300	0.37
<i>Firm_Fixed Effects</i>	<i>Incl.</i>		<.01	<i>Incl.</i>		
<i>Year_Fixed Effects</i>	<i>Incl.</i>		<.01	<i>Incl.</i>		
F-Value	2.72			2.71		
Adj R-Sq	0.475			0.493		

VI. SUMMARY

This article describes content statistics; specifically analyzed the audit report of the A+H share listed company. We found that the content of key audit matters in the auditing report were generally related to revenue recognition, fair value recognition, impairment of assets, deferred income tax and

equity trading, etc. The disclosure of key audit matters is of an industrial nature and differentiation to a certain extent. However, compared with the UK audit report, the current disclosure of key audit issues in China remains to be improved. This paper argues Chinese auditors can improve the quality of KAMs disclosure by adding graphics, giving an opinion on every key matter, and disclosing the content of the audit on the key audit matters in details.

Furthermore, this study examines how the promulgation of new auditing standards - adding key audit matters, affects investors (market reaction) and the audit quality. We conclude that there are no obvious benefits. In fact, the market did not significantly react to the disclosure of key audit matters. Besides, the disclosure of key audit matters did not demonstrate a higher audit quality (measured by unexpected accrued profits). These findings show that the newly enacted guidelines in China for adding key auditing matters are not as informative as the regulators expected, nor do they significantly alter the audit quality. However, our studies allow enriching the current international debate on the introduction of key audit matters.

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