Do Chinese investors trust expanded audit reports?

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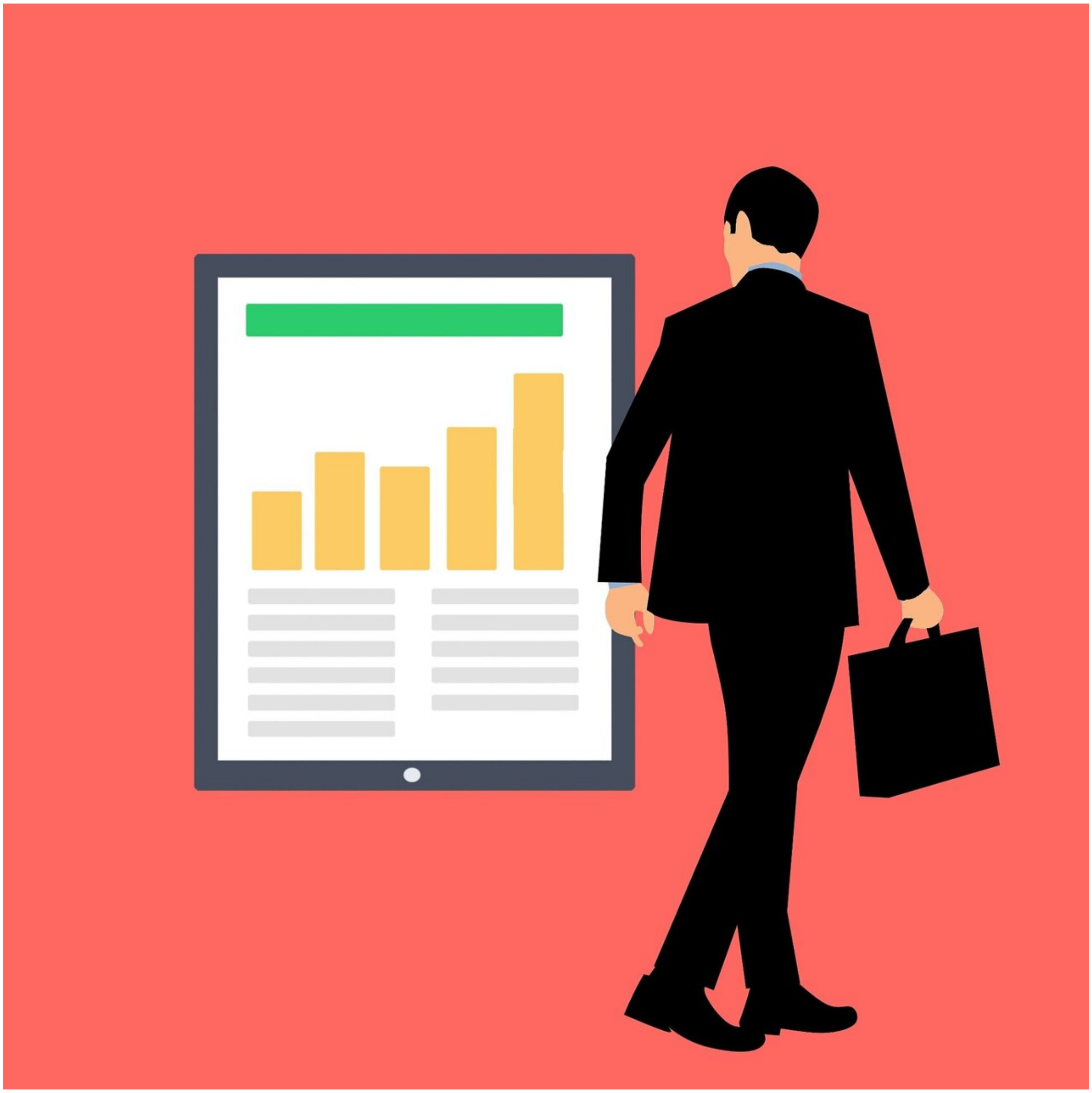

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The global financial crisis of 2007–2009 prompted calls for greater transparency in auditing processes, and since 2013, the auditors of UK-listed companies have been required to highlight key audit matters or KAMs. However, according to a paper by SMU researchers, there has been 'mixed evidence' regarding the impact of the regulation and whether investors find such disclosures useful.

SMU Associate Professors of Accounting, Goh Beng Wee and Jimmy Lee, along with co-researchers from Tsinghua University and the Central University of Finance and Economics in China, consequently decided to examine the impact of expanded audit reports on investors in a 'large and important emerging economy', namely China.

At the end of 2016, the Chinese Institute of Chartered Public Accountants (CICPA) brought in a new auditing standard, similar to its international counterpart, which requires auditors to disclose KAMs in audit reports.

The new standard was implemented in two stages: 'AH-share firms' which are listed on stock exchanges in both Mainland China and Hong Kong from 2017; and all other firms in Mainland China ('A-share firms') from 2018.

"Early studies failed to reveal significant findings, so I turned my attention to look at it from a developing country's perspective," Professor Goh said in an interview with the Office of Research. "I thought perhaps one of the main reasons why these studies couldn't find significant results could be the fact that these markets are already very developed, so investors may not find incremental information from what was said in the audit report."

KAM(paign) for information

In examining the impact of KAM disclosures in China, Professor Goh said the researchers did find significant results. "This is one of the key differences between my study and the prior studies in the developed markets."

He explained that KAMs are accounting issues that the auditor thinks will increase the risk of financial misstatements. "It can be revenue recognition, asset depreciation, goodwill, inventory, anything. So long as the auditors see this as heightening the risk of financial misstatement, they have the responsibility to set out the issue in the audit report."

The study, titled "Informativeness of Key Audit Matters: Evidence from China," states that while additional auditing information could mitigate investors' concerns, especially as there is 'limited firm-level reporting and lack of alternative sources of information' in China where the media are state controlled and censored, investors 'could become more suspicious about the quality of a firm's financial reporting.'

"That's the tension we introduce in the paper," Professor Goh said. "Information is not so readily available, but auditors are not as credible in the Chinese market, so this could lead investors to wonder whether they can be trusted."

He said the study had used three measures to analyze the impact of expanded audit reports: namely trading volumes, earnings response coefficients, and stock price synchronicity.

In essence, credible earnings should result in a stronger market reaction. "If the information is not useful to investors, we would not expect any stock market reaction. That's the presumption."

The study compared the periods before and after the introduction of the new auditing standard in China. Professor Goh said they found significant results for all three measures, but did not find any for another measure, that of abnormal returns. Although the researchers did not elaborate on this, they decided to include it nevertheless in the paper 'for completeness.'

"A pre-post research design is not as rigorous as difference-in-differences analysis, but we did use DID for robustness and we found robust results with it."

The study, which has been published online by *The Auditing Journal of Theory and Practice*, also found that expanded audit reports 'are more informative for non-SOEs (state-owned enterprises), smaller firms, and firms that have a smaller analyst following.'

The paper concludes, "Our findings may also be generalizable to other large developing economies with weak institutions and a strong SOE presence, such as Brazil, India and Russia."

Professor Goh said that while investors in developed markets may not find extended audit reports useful "because the information environment is already very good," their study, although focused on China, "can also apply to other emerging economies that similarly have a poor information environment. So investors would tend to value such disclosures more, as compared to their counterparts in the developed markets."

More information: Beng Wee Goh et al, Informativeness of Key

Audit Matters: Evidence from China, *Auditing: A Journal of Practice & Theory* (2023). DOI: 10.2308/AJPT-2020-099

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