The promoting effect of key audit matters on auditors' sense of responsibility
-- From the perspective of earnings management direction

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Abstract. IAASB and China's new audit reporting guidelines make improvements to the traditional audit report disclosure, focusing on adding disclosure of key audit matters (KAM) in the audit report, which may enhance auditor's sense of responsibility. This paper empirically analyses the promoting effect of KAM on auditor's sense of responsibility, using a sample of Chinese A-share listed companies in 2020, mediated by the direction of enterprise earnings management. Using OLS regression analysis, it is found that KAM has little effect on the positive enterprise earnings management, but a significant negative relationship on negative earnings management. In addition, it is found that: when the auditor issues a standard unqualified opinion, the trend of the negative relationship between KAM and negative enterprise earnings management can be significantly proved. Since the negative enterprise earnings management is increasing based on "accounting conservatism", this paper concludes that auditors need to improve their awareness of their responsibility.

Keywords: KAM; direction of earnings management; OLS regression; auditor's sense of responsibility.

1. Introduction

In response to the fact that with the increasingly complex financial reporting, the modeled audit report has become difficult to meet financial report users' needs about decision usefulness, the International Auditing and Assurance Standards Board (IAASB) issued a new standard on the audit report in 2015, to improve current audit report model. China issued a new standard on audit report (hereinafter referred to as the new standard) in 2016, which proposes to add disclosures of KAM to the traditional audit report, to maintain convergence with international standards. In 2017, the audit of financial statements in Chinese A+H listed companies took the lead in implementing the new standard. And the new standard was fully implemented in all Chinese listed companies in 2018.

The new standard responds to the need of financial report users for decision-useful information. It aims to raise auditors' awareness of their responsibilities, via enhancing the transparency of audits by KAM. Academic circle's views vary about whether KAM enhance auditor's sense of responsibility. Some scholars (Jixun Zhang et al., 2015; Brasel et al., 2016; Kachelmeier et al., 2014; Brown et al., 2015) believe that the disclosure of KAM could reduce auditor's responsibility. Another scholars believe KAM could improve the auditor's perception of audit responsibility for high-risk clients, in the audit pricing perspective. However, whether the new standard enhances auditor's sense of responsibility is of great interest to stakeholders, and there is not much literature that reflects the impact of KAM on auditor's sense of responsibility through the direction of enterprise earnings management.

Since it needs sufficient time from the beginning of the new standard implementation to its maturity, this paper selects Chinese A-share listed companies in 2020 as the experimental group, and conduct the OLS regression analysis to examine the impact of the new standard implementation on auditors' sense of responsibility. It is found that KAM leads to an increase in negative enterprise earnings management. To avoid scrutiny, companies will choose to manipulate their earnings management in a more covert way, which places a higher demand on auditor's sense of responsibility.

It also proves that the impact is more significant when the auditor issues a standard unqualified opinion.

This paper's contributions are as follows. First, it provides evidence for the new standard to measure auditor's sense of responsibility from the perspective of enterprise earnings management direction. The study shows that the more KAM are disclosed, the more urgent the auditor's need to enhance sense of responsibility. Second, in the perspective of audit opinion, the degree of influence of KAM on auditor's sense of responsibility under standard unqualified opinion and non-standard opinion is further measured, which enriches the research related to KAM on auditor's sense of responsibility.

2. Literature Review and Hypothesis Formulation

After the pilot of the new standard, the impact of disclosure of KAM on auditor's perception of responsibility has had mixed findings in numerous literatures. Some scholars believe that more disclosure of KAM reduces the auditor's perceived audit responsibility (Jixun Zhang et al., 2015; Dongmei Han et al., 2018). Because the disclosure of KAM can function as a reminder to information users, implying the possible risk of material misstatement of the audited entity, it could reduce the auditor's responsibility. Jixun Zhang and Dongmei Han also concluded that audit reports containing conclusive evaluations of KAM make the auditor perceive greater audit responsibility compared to audit reports without containing conclusive evaluations of KAM, which mediates the reduction in audit responsibility brought about by material misstatement cues (2018). Another view is that the disclosure of KAM creates potential expectations for users that the auditor has reduced the risk of falsifying the company's financial reports. In the event of a crisis in the company, report users will increase the auditor's legal liability (Gimbar C, Hansen B, Ozlanski M E, 2016).

In addition, some scholars have argued by experimental studies that auditors' perceived audit liability is lower when there are material misstatements in KAM. (Dongmei Han et al., 2018). Some scholars have also used audit pricing to show that auditors' risk perceptions and responsibility perceptions for high-risk clients are positively affected by the new standard (Keqin Pan, 2020).

In terms of research on enterprise earnings management, Fan Yang explores the impact of KAM on enterprise earnings management with the help of accrued earnings management (manipulative accrued profit) (2019). Xiaojun Li and Xia Li examine the impact of accounting firm reputation on earnings management using real earnings management (2017). It can be seen that there are various ways to measure enterprise earnings management, and this paper applies the modified Jones model to measure accrual earnings management.

Based on the above analysis, hypotheses are proposed as follows.

Hypothesis 1: When KAM are disclosed in the audit report, companies tend to be more inclined to negative earnings management to avoid the risk of scrutiny, thus promoting auditors to raise their sense of responsibility.

The implementation of the new standard requires auditors to disclose KAM as a way to enhance the decision usefulness of the audit report. Psychological studies show that increasing the significance of information draws attention to the information and encourages additional information processing (Haynes and Kachelmeier, 1998; Reed, 2004; Ng and Tan, 2007). If companies make positive earnings management to manipulate profits for the intention of share price decline, the possibility of detection by auditors will increase. Therefore, companies increasingly prefer to make negative earnings management, which is easily explained as "accounting conservation". Considering their potential professional risk, auditors need to raise their sense of responsibility to recognize earnings management, so that to achieve "decision-usefulness".

Hypothesis 2: When the auditor issues a standard unqualified opinion, the negative earnings management is more obvious than the non-standard opinion, which indicates that the auditors should improve their sense of responsibility in such cases.

3. Research Design

3.1 Sample Selection and Data Sources

3.1.1 Sample selection

This paper selects Chinese A-share listed companies in 2020 as the research object. Excluding ST and *ST listed companies, financial listed companies and samples with relevant data missing, a total of 3238 A-share listed companies are obtained.

3.1.2 Data sources

All financial data and audit data used in this paper are obtained from CSMAR. The data related to KAM are obtained by downloading the annual reports from Juchao Information Website and collated manually. In addition, a two-sided tailing process at the 1% level was applied to all continuous variables, so that to remove the effect of outliers. Data are processed using Excel and Stata15 software.

3.2 Model Setting and Variable Definition

3.2.1 Model Setting

This paper selects the OLS regression model to explore the effect of disclosure of KAM on auditor's sense of responsibility.

$$DA_{it} = \beta_1 KAM_{it} + \beta_2 Control_{it} + \beta_3 \varepsilon_i Year + \beta_4 \varepsilon_i Industry + \varepsilon_{it} \tag{1}$$

3.2.2 Explained variables

The explained variable of the model is accrued earnings management (divided into two experimental groups of positive DA and negative DA). A modified Jones model is used to calculate manipulative accrued profits, act as a measure of auditor's sense of responsibility. The calculation is as follows.

First, equation (2) is regressed to obtain the estimated coefficients.

$$\frac{TA_{ij,t}}{A_{ij,t}} = \beta_1 \frac{1}{A_{ij,t-1}} + \beta_2 \frac{\Delta REV_{ij,t}}{A_{ij,t-1}} + \beta_3 \frac{PPE_{ij,t}}{A_{ij,t-1}} + \beta_4 \frac{CFO_{ij,t}}{A_{ij,t-1}} + \beta_5 \frac{DCFO_{ij,t}}{A_{ij,t-1}} + \beta_6 \frac{CFO_{ij,t} \times DCFO_{ij,t}}{A_{ij,t-1}} + \epsilon_{ij,t} \tag{2}$$

Then, the regression coefficients derived from equation (2) are brought into equation (3) to find the non-manipulative accrued profit.

$$NDA_{ij,t} = \beta_1 \frac{1}{A_{ij,t-1}} + \beta_2 \frac{\Delta REV_{ij,t}}{A_{ij,t-1}} + \beta_3 \frac{PPE_{ij,t}}{A_{ij,t-1}} + \beta_4 \frac{CFO_{ij,t}}{A_{ij,t-1}} + \beta_5 \frac{DCFO_{ij,t}}{A_{ij,t-1}} + \beta_6 \frac{CFO_{ij,t} \times DCFO_{ij,t}}{A_{ij,t-1}} \tag{3}$$

Finally, the manipulative accrued profit (DA) is calculated:

$$DA_{ij,t} = \frac{TA_{ij,t}}{A_{ij,t-1}} - NDA_{ij,t} \tag{4}$$

$TA_{ij,t}$ denotes the total accrued profit of company i in industry j in year t. $A_{ij,t}$ denotes the total assets of company i in industry j in year t. $\Delta REV_{ij,t}$ denotes the increase in revenue from core business of company i in industry j in year t compared with year t-1. $PPE_{ij,t}$ denotes the net value of fixed assets of company i in industry j in year t. $CFO_{ij,t}$ denotes the net cash flow from operating activities of company i in industry j in year t. $DCFO_{ij,t}$ is a dummy variable that takes 0 of the positive value, otherwise takes the value of 1. $\varepsilon_{ij,t}$ denotes the residual term.

3.2.3 Explanatory variables

The explanatory variable of this paper is the number of key audit matter (KAM), which measures the extent of the impact of the new standard. Its sign and significance are the focus of this paper.

3.2.4 Control variables

Based on the existing literature, three types of control variables are selected in this paper. The first is the audit characteristics, including the audit opinion of company's annual report (Opinion), which is assigned as 1 for standard unqualified opinion and 0 for other opinions. It also includes the firm size (Big4), which is assigned as 1 for "Big 4" audit firms and 0 for non-Big 4. The second is the financial characteristics, including current ratio, working capital allocation (WC/CA), accounts receivable turnover (Rec), operating cash flow (CFO), DCFO, operating income growth (Growth), net profit (NP), financial leverage (Lev), and asset size (Size). The third is the company attribute characteristic variables, including the nature of equity (SOE), which are assigned 1 to state-owned enterprises and 0 to non-state-owned enterprises. Additionally, year and industry are selected as dummy variables to control for fixed effects and to overcome the endogeneity problem. (Lianghua Huang et al., 2021)

Table 1. Definitions of primary variables

Variable Type	Variable Name	Variable identification	Variable Definition
Explained variable	Manipulative accrued profits	DA	Two categories for manipulative accrued profits- positive and negative.
Explanatory variable	Number of KAM disclosed	KAM	Number of KAM disclosed in the audit report
	Current Ratio	Current Ratio	Current assets to current liabilities, used to measure the liquidity of a company's assets
	Working Capital Allocation	WC/CA	Working capital to current assets, measuring the short-term solvency of a company
	Accounts Receivable Turnover	Rec	Operating income/accounts receivable, used to measure the efficiency of capital usage
	Operating cash flow	CFO	Cash flow from operating activities/total assets
	Asset Size	Size	Natural logarithm of the company's total assets
	Financial leverage	Lev	Total liabilities/total assets, used to measure the long-term solvency of a company
Control variable	Operating income growth	Growth	Operating income growth, a measure of a company's ability to grow its business
	Net profit	NP	Measuring corporate profitability
	Audit opinion	Opinion	Categorical variables, with standard unqualified audit opinion of 1 and non-standard unqualified opinion of 0
	Accounting Firm Size	Big4	Categorical variable, take 1 for international "Big Four", otherwise take 0
	Nature of equity	SOE	Categorical variable, State-owned is 1, otherwise it is 0
	Operating cash flow loss	DCFO	Categorical variable, assigned 0 for positive operating cash flow and 1 for negative operating cash flow
	Year	Year	Year fixed effects
	Industry	IND	Industry fixed effects

4. Empirical Analysis

4.1 Descriptive statistics

From the descriptive statistics of each variable below, it can be seen that the mean value of the explanatory variable (DA) is 0.002, the maximum value is 0.156, and the minimum value is -0.241, showing that the upward earnings management is large, but the direction of earnings management varies. the mean value of KAM number is 2, indicating that the number of KAM disclosed in most audit reports is approach to 2. The mean value of current ratio is 2.248 and of the working capital allocation ratio is 0.343, indicating that the short-term solvency of listed companies is relatively high. The mean value of accounts receivable turnover is 19.531, but the large standard deviation indicates that the efficiency of capital use varies widely among companies. The mean value of operating cash flow is 0.061, showing that most companies have positive net operating cash flow. The mean value of gearing ratio is 0.420 and the minimum value is 0.069, indicating that all companies have achieved net assets, and, on average, have strong long-term solvency and low financial risk. The mean value of operating income growth and net profit is positive, with large differences between the maximum and minimum values, indicating that at the overall level, listed companies have better profitability and good growth dynamics, but with large disparities between companies. Analyzing the categorical variables, 96.67% of the listed companies were issued standard unqualified audit opinion, and only 6.47% of the companies choose international Big Four for audit. 68.03% of the companies belong to state-owned enterprise holding, and 86.38% of the companies achieve net cash inflow from operating activities.

Table 2. Quantitative variable descriptive statistical results

Variable	Sample	Mean	Std. Dev.	Min	Max
DA	3,072	0.002	0.053	-0.241	0.156
KAM	3,120	2.011	0.632	1.000	4.000
Current Ratio	3,074	2.248	1.712	0.389	11.295
Working Capital Allocation	3,074	0.343	0.398	-1.573	0.911
Accounts Receivable Turnover	3,074	19.531	59.329	0.809	717.812
CFO	3,073	0.061	0.061	-0.125	0.280
Size	3,074	22.360	1.220	20.039	26.388
Financial leverage	3,074	0.420	0.185	0.069	0.866
Operating income growth	3,074	357000000	2300000000	-8610000000	22600000000
Net profit	3,074	448000000	1050000000	-1350000000	9700000000

Table 3. Categorical variable descriptive statistical results

Variable	Value assignment	Total	Percent (%)
Opinion	1	3136	96.7
	0	107	3.3
Big 4	1	205	6.32
	0	3038	93.68
SOE	1	1017	31.38
	0	2224	68.62
DCFO	1	454	14
	0	2789	86

4.2 OLS Regression analysis

4.2.1 The relationship between KAM and the direction of earnings management

This paper divides earnings management into two sets of positive and negative measurements to better judge the impact of KAM on the auditor’s sense of responsibility. Positive earnings management is mainly aimed at raising profits, so that the company's profitability reaches the corresponding "threshold", such as avoiding the decline in stock prices and investing in listing. Negative earnings management aims to reduce profits and uses the "accounting prudence" as a pretext to smooth out financial fluctuations. In general, because a company's negative earnings management is often under the pretext of "accounting soundness", it is difficult for auditors to prove the inadequacy of their earnings management (Zhang Changhai and Wu Shunxiang, 2010). At the same time, driven by interests, companies are more likely to generate positive earnings management. It has led auditors to focus more on positive earnings management and ignore negative earnings management after the implementation of the new standard.

Table 4. KAM and the direction of earnings management

Variable	DA>0		DA<0	
	coefficient	T-value	coefficient	T-value
KAM	0.000	-0.73	-0.070^{***}	-2.84
Current Ratio	0.046	1.46	-0.014	0.27
WC/CA	0.041^{**}	2.12	0.050	0.8
Rec	0.024^{***}	4.2	0.003	0.66
CFO	-0.008	0.65	-0.060^{***}	-4.58
Growth	-0.106	-1.61	0.049	1.08
NP	0.188	1.48	0.121^{**}	2.03
Size	-0.144	-0.87	0.251^{***}	5.14
Lev	0.090	0.78	-0.235^{*}	-1.77
Opinion	-0.091	-1.16	-0.052^{***}	-4
Big4	0.010^{**}	2.14	0.015^{*}	1.95
SOE	0.010^{***}	4.32	-0.007^{**}	-2.19
DCFO	-0.011	-1.34	0.048^{***}	5.67
Constant term	0.212	1.16	-0.278^{***}	-6.63
Industry	controlled			
Year	controlled			
N	1800		1438	
Adjusted R^2	0.08551		0.2182	

Note: The superscripts *, **, *** indicate the significance level of 10%, 5% and 1% respectively (the same below).

For possible heteroscedasticity problems, a robust standard error is used to calculate the T-value to determine the significance level. From Table 4, the KAM coefficient for the positive earnings management group is close to 0 and it’s not significant. However, for negative earnings management, the KAM coefficient is -0.070, which is negatively significant at the 1% level. The above results verify hypothesis 1.

The regression results showed that the disclosure of KAM did not have a significantly large impact on the enterprise positive earnings management, but stimulated the negative earnings management. It shows that based on the new standards, auditors urgently need to enhance their sense of responsibility, focus more on the negative enterprises earnings management, in the design of audit procedures and the collection of audit evidence, so that to identify the potential financial statements manipulation.

4.2.2 KAM and the direction of earnings management in different audit opinions

In order to further examine the impact of KAM on earnings management direction, and to prove the function of KAM in urging auditors' sense of responsibility, this paper divides audit opinions into two categories, one is standard unqualified audit opinion, which indicates that auditors believe that The audited entity's financial reports fairly reflect in all material respects the financial position at the audit closing date, as well as the operating results and cash flows for the year. The second is a non-standard opinion, including unqualified opinions with a matter paragraph, qualified opinions, negative opinions and disclaimed opinions, indicating that the auditor believes the financial report disclosure of the audited entity still has matters that need to be explained, material misstatements, etc. It is generally believed that in the non-standard opinion, the auditor has already conveyed to the public a signal that the financial report disclosure of the audited entity is not fair through the audit opinion, which is more likely to identify the company's earnings management. It reflects the auditor who issued the non-standard opinion has a high sense of responsibility. However, due to the earnings management of the audited entity is too concealed, or the auditor's sense of responsibility is not strong, those who issue standard unqualified opinions may have a greater risk in accurately identifying enterprise earnings management.

Table 5. KAM and earnings management directions under different opinions

Variable	standard unqualified opinions		non-standard opinion	
	DA>0	DA<0	DA>0	DA<0
KAM	0.020	-0.093***	0.006	-0.026
	(0.23)	(-3.70)	(0.40)	(0.04)
Current Ratio	0.025**	0.013	0.009	0.163
	(0.93)	(-0.03)	(0.22)	(0.95)
WC/CA	0.076***	0.034	0.002	0.121
	(2.56)	(0.94)	(-0.03)	(0.62)
Rec	0.061	-0.003	-0.022	-0.127
	(4.09)	(-0.21)	(-0.86)	(-1.03)
CFO	-0.044	-0.064***	-0.028	-0.050
	(0.41)	(-6.80)	(-0.18)	(-0.73)
Growth	-0.098***	-0.168***	-0.022	-0.048
	(-2.59)	(-4.55)	(-0.68)	(-1.62)
NP	0.119***	0.337***	0.966***	0.311***
	(2.78)	(6.25)	(44.03)	(3.94)
Size	-0.015**	0.128**	-0.093***	0.360
	(2.05)	(2.07)	(-3.92)	(1.25)
Lev	-0.107***	-0.064**	0.041	-0.163
	(-2.58)	(-2.30)	(1.32)	(-0.82)
Big 4	0.007**	0.017***		0.447***
	(2.30)	(2.58)		(-2.99)
SOE	0.009***	-0.008**	0.004	0.015
	-4.61	(-2.47)	(0.11)	(0.30)
DCFO	-0.020***	0.060***	-0.040	0.008
	(-5.96)	(7.88)	(-1.27)	(-0.18)
Constant term	-0.015	-0.145***	1.261***	0.019
	(-0.61)	(-3.57)	(3.33)	(-0.04)
Industry		controlled		
Year		controlled		
N	1762	1369	38	69
Adjusted R^2	0.0836	0.2222	0.9875	0.2797

As can be seen from Table 5, under the standard unqualified opinion, KAM is not significant with positive earnings management, but it is negatively significant with negative earnings management at the level of 1%, with a coefficient of -0.093. In contrast to the above, the coefficient between KAM and negative earnings management is -0.070. Under the non-standard opinion, both positive and negative earnings management are not significant. The result shows that the KAM under the standard opinion have a stronger tendency to increase the negative enterprise earnings management. It proves that auditors who issued standard unqualified opinion urgently need to enhance their sense of responsibility and better in response to the earnings management of the audited entity. Assumption 2 is valid.

5. Robustness test

The existing literature uses accrual earnings management and real earnings management to measure earnings management. Accrual earnings management includes: basic Jones model, modified

Jones model, income matching Jones model, non-linear Jones model. This paper selects the earnings-matching Jones model to measure earnings management to consider the impact of earnings on manipulative accruals, and brings it into the OLS regression model. The results are as follows.

Table 6. Robust Test

Variable	DA>0		DA<0	
	coefficient	T-value	coefficient	T-value
KAM	0.012	0.24	-0.085***	-2.84
Current Ratio	0.008	0.24	0.000	0.89
WC/CA	0.020	0.43	0.008	0.3
Rec	0.044**	2.25	0.001	0.68
CFO	-0.042	-0.5	-0.063***	-2.57
Growth	-0.095***	-2.64	0.033	1.53
NP	0.164***	2.73	0.139***	2.82
Size	-0.129*	-1.66	0.088	1.35
Lev	0.059	0.73	-0.121	-1
Opinion	0.008	0.65	-0.026***	-2.87
Big4	-0.002	-0.3	0.000	0.02
SOE	0.007***	3.48	-0.005*	-1.77
DCFO	-0.010***	-3.04	0.025***	4.4
Constant term	0.095**	2.21	-0.090***	-2.82
Industry	controlled			
Year	controlled			
N	1672		1568	
Adjusted R^2	0.0381		0.0973	

The regression results in Table 6 show that KAM has little effect on the positive earnings management, but has a positive effect on negative earnings management, which urges the auditors to improve their sense of responsibility. Consistent with the previous results, the previous conclusions still hold.

6. Conclusions

This paper, taking A-share listed companies in 2020 as a sample, empirically tests the impact of the number of key audit matters on auditors' sense of responsibility through the "accrual earnings management direction". The study found that KAM enhanced the negative earnings management, and this trend is more significant in entities that have been issued standard unqualified audit opinion. The paper believes that although KAM are conducive to more adequate information disclosure of the audited entity, due to the concealment of negative earnings management, audited entity can make auditing more difficult by means of "accounting conservatism". It needs auditors, especially those issuing standards unqualified audit opinions raise their sense of responsibility and design more effective audit procedures to deal with the enterprise earnings management, so that to achieve the goal of "decision-usefulness".

Based on the perspective of "earnings management direction", this paper analyzes the impact of KAM on the auditor's sense of responsibility, and further analyzes that in different audit opinions, enriching and expanding research literatures. The research in this paper has certain limitations. It only uses the number of key audit matters as a measure of KAM, lacks the implement timing and the mining of the disclosure text of KAM. In future research, the sample size will be further expanded, and the individualized indicators of KAM will be fully considered, so that the research results will be further revised and improved.

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