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Market behavior to the introduction of Key Audit Matters: Case of a shares of cross listed companies in China

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Abstract: *The behavioral agency theory explains that the introduction of key audit matters can cause reactions or from stakeholders, positives or negatives. This study investigates the impact of the introduction of Key Audit Matters on the market behavior. By examining the period before (2014-2015) and after (2017-2017) the introduction of KAM in China, we compared the cumulative abnormal return of 52 A shares listed in both Shanghai Stock Exchange and Shenzhen Stock Ex-change. According to the Hausman test, the random effect was selected as convenient for this study and the fixed effect rejected. The results show that there is no evident impact of the introduction of Key Audit Market on the market behavior. However, we found a positive impact of the total asset on the cumulative abnormal return which means that the increase of total asset leads to a positive response of the market*

Key Word*: Key Audit Matters; Market Behavior; A shares; Shanghai and Shenzhen Stock Exchange.*

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I. Introduction

The shareholders of a companies are linked to the auditor by a report prepared and drawn up by the latter. However, these reports proved to be longer and more complex, and as a result, there was a risk of information being overloaded and less significant for report users. Recent developments in the field of auditing have led regulators and standard setters to improve the audit report model. The diversity of regulators has generated specific standards for each regulator but with similar objective, mainly, IAASB and PCAOB (IAASB 2017). As reported by the International Auditing and Assurance Standards Board (IAASB), the implementation of KAM is useful to decision-makers since there will be a particular section which will be a greater insight into the audit procedure(Bédard et al. 2016) In China, the Ministry of Finance published a new audit guide "No. 1504 Auditing Standards for Chinese Certified Public Accountants - Communicating Key Audit Matters in the audit report. They brought out 12 Auditing Standards for Chinese Certified Public Accountants ("New Audit Reporting Standards"), including "Communicating Key Audit Matters in Auditing Reports", which re-quires certified public accountants,based on professional opinion, to report the matters that are most important to the audit of the financial statements of the ongoing period, and the main information in the audit report are added to describe the selected information of the audit report. In fact, CPAs should focus on identifying key audit matters: section of high risk of important misstatement or special risks identified;significant audit opinions related to the section where the financial statements include significant management opinions (including accounting estimates that are considered to have a high level of estimation uncertainty); the impact of important transactions or events on the audit during the period. At the same time, the CPA should explain why the matter is among the most important matters in the audit and how the matter was treated within the audit procedure. The new audit reporting standards require auditors to introduce the name of the engagement partner, to represent the opinion section first, and to enhance going concern (IAASB 2017)

In their letter sent to the International Auditing and Assurance Standards Board (IAASB), the Chinese Institute of Certified Public Accountants argues that key audit matters could add useful information to users and then enhance transparency about the audit performed(District, Auditing, and Board 2013). These changes were effective for terms ending on or after December 15, 2016. The main objective of the IAASB was to properly enhance the usefulness and pertinence of the auditor's report communication, also to adjust the IAASB's accounting ISAs to take into account the evolution of national financial reporting system, while assuring that common and essential contents are communicated. Listed companies in both, Shanghai and Shenzhen stock exchange have approved a new audit to meet the growing expectations of stakeholders.

The purpose of this paper is to investigate the reaction of investors to the introduction of KAMs for firms that issue both A and H shares in mainland china. A+H shares are among the one who took leads in applying the new audit standards in their report for the period ending by December 2016. This study examines 69 A+H shares listed companies in both Shanghai stock exchange and Shenzhen stock exchange and which ,by the end of March 2017, had issued audit reports in agreement with the new audit report standards. The key audit

matters disclosed were mainly in the area of asset impairment, followed by revenue recognition and mergers and acquisitions.

The improvement of audit report in 2016 aims to increase the information significance and decision-making relevance of audit reports in order to respond to the demands of investors for auditors to improve their practice. Studies over the past five years have provided important information on the behavior of investors to the improvement of audit report Surveys such as that conducted by (Gold and Heilmann 2019) have shown that experimental findings support the higher possibility of the decisions of financial statements users to get influenced by KAMs, and therefore the possibility of turning the concern of users of financial statements to the appropriate field and of reducing attempts to manage investor's profits, especially non-professional investors. In his study, (KKhler, Ratzinger-Sakel, and Theis 2016),has observed a significant communicative meaning only for professional investors (no communicative meaning for nonprofessional investors) .

This study will contribute first to the literature on audit report by enhancing the findings of previous studies on the improvement of auditing standards in China .Second, most of the research on the developed auditor's report that may directly inform standard-setting are experimental and archival such as (Bradbury and Almulla 2018) and (Sirois, Bédard, and Bera 2018), this research will use a quantitative model to assess the investor's reaction.(Li 2017)in his study on how the improvement of audit standards affects investor's reactions in China, he used the cumulative abnormal return in his measurement and find that there are no obvious benefits. As long as there is a lack of archival data, the actual introduction of key audit matters in China need to be developed (Gold and Heilmann 2019). It is within this framework that this study is elaborated.

II. Theoretical framework and hypotheses

The behavior of investors is conceived in different ways by psychologists, economists, and sociologists. First, economists' research on investor behavior has concentrated on the rationality or irrationality of investor decision-making mechanisms. As for sociologists, they concentrated on the social environment to explain the behavior of investors. Finally, psychologists illustrate investor behavior by concentrating on individual characteristics. Investors are defined as persons who gain or collect money from a third party on a monthly or occasional base and invest in different investments such as stocks, mutual funds, deposits to save for future requirements.(Shafi 2014)

The behavioral agency theory explains that the introduction of key audit matters can cause reactions or from stakeholders, positives or negatives (Wiseman and Gomez-Mejia 1998).However, it is not clear that even if auditors add additional in-formation, they improve the quality of the audit report. This study aims to investigate the reaction of the investor to the introduction of key audit matters, to do that, we examine the reaction of companies that issue A+H shares to the announcement of KAMs.

Several studies have been conducted on the various factors influencing the investor. (Thaler 1985) investigated behavioral finance on the NEW YORK STOCK EXCHANGE by asking the following question: "Is the stock market overreacting?". According to their results, research in experimental psychology advises that the majority of people "overreact" to unexpected and dramatic news events. (Al-Tamimi 2006) examined the factors manipulating investor behavior in the United Arabic Emirates. In his findings, he grouped the most influential into six groups namely; the expected profits of the companies, enrich themselves quickly, the negotiability, the past performances of the shares of the companies, the governmental participation, the establishment of the standardized financial market. In contrast, the least influential were categorized into five groups, namely predicted losses in other local investments that minimize risk, expected losses in international financial markets, the opinions of family members, and a deep feeling of the economy. Unexpectedly, they found that two factors had the least impact on UAE investor behavior, namely religious reasons and the opinion factor of family members.

(Baker, Hargrove, and Haslem 1977) argued that investors take into consideration the financial stability of the firm, expected income and dividends. In their study on risk-return priorities of investors noted that investors have a rational way of behaving, given the risk-return adjustment of the investment. Behavioral finance has accomplished an improvement in the explanation of the behavioral aspects of investment decisions. Empirical studies focused on institutional investors, while little attention is paid to the behavior of individual investors which is central to this research. However, it should be noted that almost all previous studies have examined the behavior of investors in industrialized countries (United States, United Kingdom, and Canada).

Considering behavioral theories, they predict a pattern of abnormal return marked by a short-term trend which overturns over the long term .(Barberis, Shleifer, and Vishny 1998)suggest a model of investor behavior based on two aspects of judgment: conservatism and representativeness. Conservatism leads investors to update their opinions very slowly to new evidence. Representativeness leads them to give much importance to recent trends in data despite the low probability that such a trend will occur in the population. Conservatism leads investors to under-react in the short term, which, combined with representative-ness, leads to long-term performance reversals.

Cross-listing is a result of the introduction of international markets of many companies in china. The financial market of mainland china is all the more developed that even the protection of the investors is ensured there and that is favored by the fact that the legal system of mainland china follows the common system rules. Accordingly, listed companies are also subject to the supervision of the China Securities Exchange and the Hong Kong Stock Exchange to reduce the risk of information asymmetry to a certain extent. However, cross-listed companies are still heavily influenced by the institutional strength of the country or region where they are located, and the more prominent feature of the mainland capital market is that the government intervenes more in listed companies. The economic effects of key audit questions remain. KAMS has a more informative value than symbolic and as a result, the financial markets react in different ways. The financial consequences of the most audit questions are contentions. The primary see is that when key review questions are published, the level of information inconsistency between auditors and investors of reports is decreased. In this case, the key audit question may be the suitable solution to the requirements of the investors. As long as the KAMs add more information to investors that induce that the markets have reacted to their information. Therefore, this paper formulate the following hypothesis:

H1: the introduction of Key Audit Matters can positively impact the investor's reaction

The overall structure of the study takes the form of five sections, including the introduction, the theoretical framework and hypothesis, the research method, data analysis, and conclusions and suggestions for further research.

III. Research Method

This study will use secondary data based on 69 financial annual reports of the selected companies listed in both, Shenzhen stock exchange and Shenzhen stock exchange. The data was collected from CSMAR and RESSET databases.

First, we exclude companies with missing data within 3 days before and after the publication date of the audit report and within the estimation period which is 100 trading days. Finally, 52 samples were obtained, 39 in Shanghai stock exchange and 13 in Shenzhen Stock exchange.

There are various models used by previous studies to measure investor reaction, such as (Jones 1991; Weston 1971; Gutierrez et al. 2018). The event study method generally deviates from 0 by examining the cumulative excess return of a stock within a research window of an accounting event. The main model applied in this study is based on cumulative abnormal return. According to (Garfinkel and Sokobin 2006), abnormal return captures the change in investor's reaction to an event announcement. Based on models cited below, we formulate our models as follow:

CABRit=α1+αLOGMi,t+αROAi,t+αLOSSi,t+αMTBi ,t+αDEBTi,t+αKAMi,t+εi,t

We measured the investor reaction by the absolute value of cumulative abnormal return 3 days surrounding the publication date of the audit and 100 trading days as estimation period. We control the companies size by:

- The natural logarithm of total assets (LOGMKT)
- Return on assets (ROA) calculated by the net income dived by total assets
- The market to book value ratio (MTB) is calculated by market value divided by the book value
- The leverage (LEV) calculated as total debt dived by total asset
- Whether the companies has disclosed Key audit matters in the annual report or not (KAM), we indicated 1 if the companies dis-closed KAM and 0 otherwise
- An indicator equal to 1 if the companies's net asset is less than 0 and zero otherwise (LOSS).

First, the date of the issue of the audit report is used as the event date T = 0. If there is no transaction on that day, it is postponed to the next trading day. Whereas, 3 trading days [-3, 3] before and after the date of publication of the audit report will be used as the event window.

Rit = αi + βiRmt + cit (1)

In Equation 1, Rit represents the daily rate of return of the i stock (taking into account cash dividend reinvestment), and Rmt represents the re-turn of each market (Shenzhen and Shanghai).

According to equation (1), after multiple regression analysis to estimate the α and β coefficients within 100 days, we then calculate the daily excess return rate of individual stocks in the window period:

ARit = Rit-α̂i-β̂iRmt (2)

Secondly, we use formula (3) to obtain the cumulative excess return CAR of individual stocks during the window period:

$$CARi[t1, t2] = \sum_{t1}^{t2} ARit \quad (3)$$

Finally, we conducted a univariate statistical analysis of the cumulative excess return (CAR) to confirm the information content of key audit matters.

IV. Data analysis and discussion

Table 1a and table 1b provide the results obtained from the descriptive analysis for the pre-period and post-period. Since this paper is based on event study, we made a comparison of means of pre-period and post period of both dependent and independent variables in table 2. The results show that the mean of our dependent variable (CABR) is higher in the post period at 0.0566 in comparison of the pre period at 0.0393 ($p<0.01$). This result provides prior evidence that the abnormal return increased during two years after the introduction of Key Audit Matters. Based on the same results, Table 2 illustrates a decrease of the natural logarithm of total asset, a decrease of re-turn on asset, and an increase of market to book ratio.

TABLE 1 DESCRIPTIVE STATISTICS (PRE-PERIOD)

VAR	MEAN	MEDIAN	MAXIMUM	MINIMUM	STD. DEV.
CABR	0.039378	0.028085	0.188992	0.000128	0.039186
LOGMKT	25.29685	25.54748	28.09821	21.04036	1.491699
ROA	0.037845	0.030600	0.282286	-0.103873	0.044847
MTB	0.865135	0.878435	1.000051	0.406123	0.115178
LEV	0.402408	0.203918	2.131540	3.51E-05	0.482618
LOSS	0.960784	1.000000	1.000000	0.000000	0.195066

TABLE 2 DESCRIPTIVE STATISTICS (POST-PERIOD)

VAR	MEAN	MEDIAN	MAXIMUM	MINIMUM	STD. DEV.
CABR	0.056662	0.033296	0.917950	0.002265	0.113229
LOGMKT	24.99782	25.22234	28.00353	20.77876	1.515998
ROA	0.029775	0.026972	0.131390	-0.148266	0.037104
MTB	0.872756	0.903217	1.018066	-1.254116	0.229344
LEV	0.533513	0.234631	9.302528	0.000104	1.047554
LOSS	0.951923	1.000000	1.000000	0.000000	0.214965
KAM	1.000000	1.000000	1.000000	1.000000	0.000000

Table 3

VARIABLES	Pre(KAM=0)	POST (KAM=1)	DIFFERENCES
CABR	**0.039378**	**0.056662**	-0.01728
LOGKMT	**25.29685**	**24.99782**	0.29903
ROA	**0.037845**	**0.029775**	0.00807
MTB	**0.865135**	**0.872756**	-0.00762
LEV	**0.402408**	**0.533513**	-0.13111
LOSS	**0.960784**	**0.951923**	0.008861

The results of the correlational analysis are presented in table 3.First, during the pre-period, Cumulative Abnormal Return (CAR) is positively related to the natural logarithm of total asset (LOGMKT). In addition to that, we found a negative correlation between Cumulative Abnormal Return and Return on Asset, Market to book ratio and leverage. Finally, the observation in the post-period shows a positive relation-ship between the Cumulative Abnormal Return (CAR) and Return on asset and Market to Book ratio. Leverage appeared to be negatively related to the Cumulative Abnormal Return. Interestingly, KAM was not found to be linked to either cumulative abnormal performance or other variable, contrary to expectations. The results shows that the introduction of Key Audit Matters has no significant effect on the market behavior.

TABLE 4 CORRELATION MATRIX (Pre-period)

	CAR	ROA	MTB	LEV	LOGKMT	LOSS
CAR	1.0000					
ROA	-0.0228	1.0000				
MTB	-0.0487	0.2217	1.0000			
LEV	-0.0188	-0.2825	-0.5538	1.0000		
LOGKMT	0.0031	-0.0655	-0.3584	0.1867	1.0000	
LOSS	0.1017	0.4087	0.0954	0.0262	0.1210	1.0000

TABLE 5 CORRELATION MATRIX (Post-period)

	CAR	ROA	MTB	LEV	LOGKMT	LOSS
CAR	1.0000					
ROA	-0.0228	1.0000				
MTB	-0.0487	0.2217	1.0000			
LEV	-0.0188	-0.2825	-0.5538	1.0000		
LOGKMT	0.0031	-0.0655	-0.3584	0.1867	1.0000	
LOSS	0.1017	0.4087	0.0954	0.0262	0.1210	1.0000
KAM	.	.	.	.	.	.

Table 6 Regression results (Fixed effect)

	Pre period N=102			Post period N=104		
Variables	Coeff.	Std.err	P	Coeff.	Std.err	P
KAM				0	(omitted)	
LOGKMT	0.055784	0.040855	0.1788	-0.1288709	0.1030444	0.217
ROA	-0.225247	0.230424	0.3334	2.189463	1.309761	0.101
MTB	-0.265284	0.156488	0.0968	0.033003	.4194967	0.938
LEV	-0.111569	0.047254	0.0225	-0.0165099	0.1205213	0.892
LOSS	0.033239	0.034053	0.3341	-0.1615979	0.1168549	0.173
CO	-1.120779	1.078287	0.3040	3.346795	2.584413	0.202

Table 7 Regression results (Random effect)

	Pre period N=102			Post period N=104		
Variables	Coeff.	Std.err	P	Coeff.	Std.err	P
KAM				0	(omitted)	
LOGKMT	-0.001181	0.002904	0.6851	0.0009975	0.0075866	0.175
ROA	-0.083158	0.102853	0.4208	0.5918962	0.4368516	0.967
MTB	-0.040232	0.044351	0.3666	-0.0045178	0.1084468	0.989
LEV	-0.008688	0.010298	0.4009	-0.0003284	0.0247318	0.895
LOSS	0.032174	0.023147	0.1678	-0.0613609	0.070504	0.384
CO	0.079789	0.092426	0.3901	0.0766325	0.2185622	0.726

Note: significant level at 0.05

The results obtained from fixed effect and random effect are presented in table 6 and table 7. To distinguish between these two effects, we used Hausman test (see table 8) and it reveals that Random effect is accepted for this study. As shown in table 7, in the pre period, the natural logarithm of total asset (LOGKMT) has a non-significant negative relationship with the cumulative abnormal return (CABR), unlike the post period where the relationship turns into a positive significant one, which means that the increase of 1% of the natural

logarithm of total asset (LOGKMT) induces a de-crease of 0.11% of the cumulative abnormal return (CABR) in the pre period , while in the post period, an increase of 1% of the natural logarithm of total asset (LOGKMT) generate an increase of 0.09% of the cumulative abnormal return (CABR). The re-turn on asset (ROA) and market to book ratio (MBT) have a negative significant impact on the cumulative abnormal return (CABR) in the pre-period but with the implementation of Key Audit Matters, their impact is no longer significant. Contrary to the assumption, we didn't find any impact of the key audit matters (KAM) on the cumulative abnormal return (CABR).

In summary, these results show that the introduction of Key Audit Matters doesn't impact the market behavior. This finding broadly supports the work of other studies in this area linking market behavior with the introduction of Key Audit Matters in china.(Li 2017)in his study used the fixed effect to interpret his results and found that the market didn't consider-ably respond to the introduction of KAM. There are similarities between the results found by (B Bdard, Gonthierr Besacier, and Schatt 2018) in this study and those described by (Carver and Trinkle 2017).This latter used an experimental method to examine how the new audit standards impact nonprofessional investor's valuation judgment, he found that the introduction of CAM (Critical Audit Matters) did not influence investor's valuation judgment.This study didn't run a robustness test since it is a comparative study. Taken together, these results suggest that there is not an evident impact of the introduction of Key Audit Matters on the market behavior.

V. Conclusion and Recommendations

The present study was designed to determine the reaction of A shares of cross-listed companies to the introduction of Key Audit matters, to do so, we used cumulative abnormal return as proxy. We performed a Random Effect to run a comparative study of the pre-period (2014-2015) and the post-period (2017-2018) for 52 A shares listed in both Shenzhen stock exchange and Shanghai Stock Ex-change. The results show that there is no evident impact of the introduction of Key Audit Matters on the market behavior. However, this study has also shown that a positive significant impact of the natural logarithm of total asset (LOGKMT) on the cumulative abnormal return (CABR).This findings support previous studies with the same pur-pose as this paper (Li 2017; Goh, Li, and Wang 2019).

This work contributes to existing knowledge of audit report by providing enhancement of the findings of previous studies on the improvement of auditing standards in China (Bédard, Gonthier-Besacier, and Schatt 2018).This study contributes to the literature on market behavior and especially on the reaction of A shares of cross-listed companies to the introduction of Key Audit matters. Although market reaction to the introduction of key audit matters studies have already been conducted most of them are based on qualitative analysis and archival data (B Bdard, Gonthierr Besacier, and Schatt 2018; Gold and Heilmann 2019) .

(Li 2017) in his study on how the improvement of audit standards affects investor's reactions in China, he used the cumulative abnormal return in his measurement and find that there are no obvious benefits. Due to the lack of archival data, the actual introduction of key audit matters in China need to be developed(Gold and Heilmann 2019). It is within that framework that this study add to the growing body of research that indicates that the introduction of Key Audit Matters influences the market behavior.

One source of weakness in this study which could have affected the measurements of market behavior was small sample size due to the fact that some companies didn't publish their annual report which brought us to exclude them from the sample size. Further research might expand the sample and consider also other type of shares of companies listed in china. More research using more proxy to assess the market behavior is needed to establish a greater degree of accuracy on this mat-ter.

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