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Research on the Impact of Disclosure of Key Audit Matters on Corporate Financing Constraints

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Abstract: This paper studies the impact of key audit disclosures on corporate financing constraints through empirical analysis. Although the disclosure of key audit matters can help to reduce the information differences between management and investors and improve the audit quality, such disclosure may also be regarded as a risk signal, and the warning function to investors may cause the difficulty of corporate financing to increase. This study concludes that the increase in the number of key audit disclosures will make corporate financing more difficult. When an enterprise announces more key audit matters, the market may regard them as a stronger risk signal, causing investors to be more cautious in making investment decisions, thus increasing the financing difficulty of the enterprise. However, in companies with large board sizes, the disclosure of key audit matters can alleviate the financing constraints. Larger boards are more likely to make the right decisions and therefore may disclose fewer risky aspects of key audit matters. This study provides a new understanding of key audit issues in financing activities and a useful reference for the possible impact of macro-policy adjustments on corporate profitability. In addition, the research also provides useful information support for enterprises to understand and adapt to the new auditing standards.

Keywords: Key audit matters, Corporate financing constraints, Corporate governance, Board size.

1. Introduction

As the International Standards on Auditing (ISAs) continue to evolve, the International Institute of Certified Public Accountants' Audit Standards Committee (IAASB) updated its standards on auditing in 2015, requiring auditors to detail key audit matters in their audit reports. In line with the international reform trend, China updated its own auditing standard system in late 2016, including Auditing Standard 1504, which focuses on how to effectively communicate key audit matters in audit reports. It is proposed to include the disclosure of key audit matters in the audit report, so as to enhance the transparency of the audit work performed by the auditor and further improve the communication effectiveness of the audit report. In China's capital market, due to the imperfect system, enterprises are generally facing the challenge of financing constraints. This kind of challenge not only hinders the sustainable and healthy development of enterprises, but also reduces the allocation efficiency of social resources and adversely affects the smooth operation of the national economy. The dilemma of "financing is difficult and financing is expensive" encountered by enterprises in essence limits the possibility of their high-quality development. The research on the disclosure of key audit matters puts forward a new perspective to explore the relationship between corporate performance and financing constraints. Previous studies have tended to focus on financial statement data while ignoring key audit issues in audit reports. The focus of research has shifted from financial statement data to audit reports, which provides new ideas and methods for studying corporate performance and financing constraints. Macro-policy reform on the efficiency of enterprises.

2. Literature Review

2.1. Literature on key Audit Matters

Brant and Glover (2016) believe that more disclosure of key audit matters can enhance the value of financial reporting, provide practical information for users and enhance transparency, while helping non-professional investors and financiers to gain a better understanding of listed companies. Reid et al. (2017) found that the disclosure of key audit matters is related to the increase in stock trading volume through the study of UK listed companies, indicating that this may affect the company value. Sirois et al. (2018) found that increased disclosure may increase the focus on the audit report and enhance the usefulness of the financial statements, but may also decrease the focus on other parts of the statements. It is also found that the disclosure of key audit matters increases the cost of equity capital of enterprises by enhancing the degree of investors' perception of risks.

2.2. Research on Enterprise Financing Constraints

In their 1984 study, Myers and Majluf first emphasized that the information differences that prevails in financial markets will cause enterprises to bear higher costs when seeking external capital. The difference between this cost and the cost of financing within the enterprise reflects the financing constraints faced by the enterprise. In the framework of modern financing theory, defined the financing constraint as that when facing the investment opportunity, the enterprise needs to seek external financing sources due to the shortage of its own capital, thus falling into the difficult problem of fund raising. Also, enterprises with good internal control can win the trust of external investors due to their high management level and risk identification ability, thus reducing the difficulty and cost of financing.

3. Relevant Theories and Hypothesis

In the MM theoretical framework of Modigliani and Miller, a core assumption is that the capital market is completely competitive, there is no transaction cost, and all market participants can obtain complete information. However, the real world market is far from ideal and information differences is the norm. In order to make more informed investment decisions, investors must strive to obtain more information and assess the accuracy of this information, which naturally results in information costs. By improving the level of information disclosure, enterprises can effectively reduce the problem of information differences, thus improving the operation efficiency of capital market and the rational allocation of resources, as shown by the research of Liu Dongbo (2018).

However, the disclosure of key audit matters may increase the audit risk and increase the financing constraint. The disclosure of key audit matters requires auditors to identify and report in the audit process what they consider to be the most critical issues, which are generally related to higher audit risks. Therefore, disclosure of these matters may expose the Company to higher audit risk, especially when these issues involve significant uncertainties or judgements.

If the number of key audit matters is large or significant issues are involved, creditors may consider the credit risk of the enterprise to be high and may therefore demand higher interest rates or impose more stringent financing terms. Combined with the above, the following assumptions are put forward.

H1: disclosing more key audit items will add corporate financing constraints.

$$Y_{i,t} = \alpha + \beta_1 X_{i,t} + \gamma Z_{i,t} + \mu_i + \delta_t + \varepsilon_{i,t}$$

Board of directors represents the interests of shareholders to a certain extent, thus affecting the company's decision-making and disclosure. Different board sizes may lead to different opinions on risk identification and response, and then affect the company's financing strategy and decision-making. A large-scale board of directors may make accurate decisions more effectively. The board of directors plays an important role in risk management. Combined with the above, the following assumptions are put forward.

H2: The bigger the board of directors, the more relaxed the financing constraints.

4. Research Design

4.1. Data and Samples

This paper takes the A-share listed companies from 2016 to 2022 as the research object, excludes the financial industry, ST and ST* enterprises, and enterprises lacking important data, and performs tail reduction on the continuous variables involved. The data of relevant enterprises are from CSMR database.

4.2. Models and Variables

This paper uses fixed effect regression model to examine how key audit issues affect corporate financing constraints. This model allows us to accurately identify and control the impact of individual corporate characteristics on financing constraints, thus more accurately analyzing the role of key audit issues in it.

4.2.1. Interpreted variables

This paper uses SA index to measure the degree of corporate financing constraints. Y is the interpreted variable. According to the formula used, the calculated SA index is negative, which means that with the increase of SA index, the intensity of financing constraints faced by enterprises will also increase accordingly.

4.2.2. Explanatory variables

Based on the assumptions in this paper, the disclosure characteristics of key audit matters are used as the explanatory variable, and the disclosure amount of key audit matters is X. The amounts disclosed for key audit matters are based on actual conditions.

4.2.3. Regulating variables and Control variables

This paper refers to the empirical model of Wang Ruikun (2021) and other scholars, taking Growth, Lev, BM, ROA1, Dual, Big4, Liquid as the control variables. And the board size was used as the adjusting variable.

See the following table for the definition of variables (Table 1):

Table 1. Definition of variables

Type of variable	Variable name	Variable symbol	Definition
Explained variable	Financing constraints 1	SA	SA index
Substitute variable	Financing constraints 2	WW	WW index
Substitute variable	Financing constraints 3	FC	FC index
Substitute variable	Financing constraints 4	KZ	KZ index
Explanatory variable	Disclosure of key audit matters	Audit No.	Number of key audit matters disclosed
Regulated variable	Company size	Size	Natural logarithm of the annual total assets
Controlled variable	Increase rate of business revenue	Growth	Operating income of this year / previous year-1
Controlled variable	Asset-liability ratio	Lev	Total liabilities / total assets
Controlled variable	Book market value ratio	BM	Book value / market value
Controlled variable	Total capital earnings rate	ROA1	Net income / total assets
Controlled variable	Two jobs in one	Dual	Whether the chairman and the general manager are the same person is 1, otherwise 0
Whether the four big	Whether the big four	Big4	Whether it is audited by the Big Four accounting firms, it is 1, otherwise 0
Controlled variable	Liquidity ratio	Liquid	Current assets / current liabilities
Regulated variable	Board size	Board	The number of directors takes the number of the log

5. Empirical Research

5.1. Descriptive Statistic

According to the descriptive statistical results in Table.2, the SA index of corporate financing constraints is less than 0, with an average value of -3.907, but the minimum value and the maximum value are quite different, indicating that the financing constraints of enterprises have some differences before. The average value of Audit number is 2.041, and the maximum value is 6, indicating that most enterprises will disclose about 2 key audit items, and some enterprises will disclose 6 key audit items at most once. The standard deviation of Growth, Lev, BM, ROA1, Dual and Big4 is small, and the gap between these samples is relatively small. Relatively speaking, the standard deviation of liquidity and Size is greater than 1, showing certain differences.

Table 2. Descriptive Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
SA	16041	-3.907	.247	-4.558	-3.187
WW	16041	-1.024	.076	-1.264	-.803
FC	16041	.42	.277	0	.98
KZ	16041	1.668	1.97	-8.693	7.37
Audit No.	16041	2.041	.647	1	6
Board	16041	2.112	.195	1.609	2.708
Size	16041	22.593	1.321	19.807	26.452
Growth	16041	.162	.374	-.658	3.558
Lev	16041	.453	.188	.051	.902
BM	16041	.676	.257	.102	1.246
ROA1	16041	.035	.069	-.373	.247
Dual	16041	.295	.456	0	1
Big4	16041	.076	.265	0	1
Liquid	16041	2.125	1.977	.268	18.701

5.2. Empirical Test and Analysis

In Table.3, according to the model (1), observing the coefficients of other control variables, the variables that have significant positive correlation with corporate financing constraints are Size, Growth, Lev, Dual, Big4, Liquid, which shows that these can affect corporate financing constraints, and their increase will make corporate financing more difficult. The significant negative correlation variable with corporate financing constraints is BM, which is a variable to ease financing constraints. There is also a negative correlation with ROA, which is not significant, indicating that it has little impact on corporate financing constraints.

Table 3. Benchmark regression (1) and regulatory effects (2)

	(1)	(2)
	SA	SA
Audit No.	0.0143***	-0.1014***
	(4.90)	(-3.39)
Size	0.0332***	0.0348***
	(16.21)	(16.80)
Growth	0.0301***	0.0297***
	(5.68)	(5.61)
Lev	0.0381**	0.0362**
	(2.48)	(2.36)
BM	-0.0470***	-0.0475***
	(-4.91)	(-4.96)
ROA1	-0.0072	-0.0096
	(-0.23)	(-0.30)
Dual	0.0623***	0.0597***
	(15.13)	(14.41)
Big4	0.1151***	0.1142***
	(15.38)	(15.28)
Liquid	0.0172***	0.0169***
	(13.87)	(13.67)
Board		-0.1631***
		(-5.39)
c.Board Audit No.		0.0546***
		(3.89)
_cons	-4.5461***	-4.2337***
	(-78.13)	(-49.64)
N	16,041	16,041
r2	0.1538	0.1561
year	yes	yes
industry	yes	yes
t statistics in parentheses * p < 0.1, ** p < 0.05, *** p < 0.01		

After the interaction item is added to model (2), the coefficient of interaction item and corporate financing constraint is -0.1631, the coefficient becomes negative, and the result is significant at 1%, indicating that the board size has a significant moderating effect on the relationship between key audit matters and corporate financing constraint, indicating that the board as a moderating variable can change the effect of key audit matters disclosure from increasing financing constraint to easing financing constraint.

There is a positive correlation between the number of key audit disclosures and corporate financing constraints. Although the disclosure can help to reduce the information difference between management and investors, improving the audit quality, it may be regarded as a risk signal, and its effectiveness in reducing information differences may not be enough to offset its warning effect to investors. When an enterprise announces more key audit matters and sends out a risk signal to the market, the risk signal has a stronger impact on investors, causing investors to be more cautious when making investment decisions, thus increasing the financing difficulty of the enterprise. However, in companies with large boards, the disclosure of such key audit matters has a mitigating effect on the financing constraints. Under the larger board of directors, the internal control and audit quality of the enterprise may be higher, which improves the confidence of investors and protects their rights and interests, thus reducing the financing cost and easing the financing constraint. In addition, the larger board is more likely to make the right decisions and therefore may disclose fewer risky aspects of key audit matters.

5.3. Robustness Test

In order to test the robustness of hypothetical H1 results, referring to other literature practices, WW, FC and KZ indexes are used instead of SA indexes for regression test. The greater the values of these indexes, the higher the degree of financing constraints. In model (2), the substitution variables are substituted for regression analysis, and the results are shown in Table 4 The regression coefficient of key audit items to financing constraints is still positive at the level of 1%, and the results are significant. This result is consistent with the previous conclusion, which proves that the research conclusion is robust.

Table 4. Robustness test

	(1)	(2)	(3)
	WW	FC	KZ
Audit No.	0.0010***	0.0072***	0.0538***
	(2.61)	(4.84)	(3.57)
Size	-0.0464***	-0.1886***	-0.0401***
	(-175.38)	(-180.87)	(-3.78)
Growth	-0.0435***	0.0065**	-0.0716***
	(-63.55)	(2.40)	(-2.61)
Lev	0.0242***	-0.2258***	5.5254***
	(12.22)	(-28.86)	(69.48)
BM	-0.0077***	0.1670***	-1.6144***
	(-6.24)	(34.22)	(-32.55)
ROA1	-0.1883***	0.4769***	-9.8324***
	(-46.22)	(29.68)	(-60.21)
Dual	-0.0015***	0.0136***	-0.0661***
	(-2.76)	(6.50)	(-3.10)
Big4	-0.0032***	0.0414***	-0.1503***
	(-3.31)	(10.88)	(-3.88)
Liquid	0.0002	0.0009	-0.1395***
	(1.47)	(1.39)	(-21.74)
_cons	0.0127*	4.6491***	0.5007*
	(1.69)	(156.97)	(1.66)
N	16,041	16,041	16,041
r2	0.8498	0.8254	0.6438
year	yes	yes	yes
industry	yes	yes	yes
t statistics in parentheses * p < 0.1, ** p < 0.05, *** p < 0.01			

6. Conclusion

The paper uses the financial report and audit report data of A-share from 2016 to 2022 to construct a regression model, and analyzes the disclosure of key audit matters and the correlation between the number and corporate financing constraints. The research conclusions are as follows: (1) The more the number of key audit matters disclosed, the more the equity finance cost of the enterprise will increase. (2) The larger the board of directors, the better the financing constraint of the enterprise will be eased. However, the data sample of this study is limited to the A-share market and does not take into account the data of H-share listed companies. Therefore, the research conclusion may not be fully applicable to other securities markets, and its external effectiveness has certain limitations. In addition, key audit matters can be broken down according to their contents. Different types of key audit matters may require us to conduct more in-depth research and discussion.

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