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Public Communication of Audit Risks and Related-Party Transactions: Evidence from China

Abstract

This paper examines whether and how firms' engagement in related-party transactions (RPTs) is shaped by public communication of audit risks as required by the expanded audit report. Using the phased regulatory changes in China and a DID design with firm fixed effects and matching, we find that firms significantly reduce their RPTs after the adoption of EARs. To investigate potential mechanisms, we find that (1) investor scrutiny increases after the adoption of EARs; (2) the reduction of RPTs is more pronounced when EARs are more likely to attract investor attention; (3) the reduction of RPTs is weaker when firms are less concerned about investor scrutiny. The results suggest that EARs can attract investor scrutiny and increase the possible penalty associated with self-dealing, thus motivating firms to reduce RPTs.

Keywords: Related-Party Transactions; Real Effects of Disclosure; Public Communication of Audit Risks; Expanded Audit Report; China; RPT Auditing; Self-Dealing

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Public Communication of Audit Risks and Related-Party Transactions: Evidence from China

1. Introduction

In this paper, we examine whether and how firms' engagement in related-party transactions (RPTs) is shaped by public communication of audit risks as required by the expanded audit report. Corporate insiders often use RPTs to divert corporate wealth to themselves, which the literature refers to as "self-dealing" or "tunneling."[1] Anecdotal evidence also highlights the prominent role of opportunistic RPTs in high-profile accounting scandals. It is therefore important to curb opportunistic RPTs to assure the fair presentation of financial statements and to protect minority shareholders (Shleifer and Vishny 1997; Djankov et al. 2008; OECD 2009; 2012).

Realizing that external auditing potentially plays an important role in addressing RPTs, audit regulators have issued rules to strengthen auditors' scrutiny of RPTs.[2] However, the traditional model of the audit report restricts the auditor's role in RPT auditing. As the main product of the external audit, the traditional audit report operates on a pass/fail basis, which only provides an unqualified vs. qualified opinion without additional firm-specific information. Auditing RPTs represents a challenge for external auditors as it involves complex audit procedures and significant levels of professional judgment (Gordon et al. 2007; Fang et al. 2018).[3] The risk of material misstatements is also greater for RPTs because they present a

[1] For example, the accounting frauds at Enron, WorldCom, and Tyco in the U.S., Parmalat and Bremer Vulkan in Europe, and Kangsai in Asia, all involve RPTs. See discussions in Gordon et al. (2007) and Bennouri, Nekhili, and Touron (2015).

[2] See for example IAASB (2008) and PCAOB (2014). The Securities Exchange Act of 1934 also requires each audit of the financial statements of an issuer to include "procedures designed to identify related party transactions that are material to the financial statements." See Section 10A(a)(2) of the Act, 15 U.S.C. §78j–1(a)(2).

[3] Beasley, Carcello, and Hermanson (2001) find that audit failures associated with RPTs are among the top ten reasons for audit deficiencies.

greater opportunity for collusion, concealment, or manipulation by management (IAASB 2008; PCAOB 2014). However, until recently, information about auditors' assessment of audit risks and their procedures to mitigate those risks were unknown to the public due to the binary model of the audit report.[4]

In response to the strong interest of investors in enhanced communication from auditors, standard setters have taken steps to promote audit report reforms (FRC 2013; IAASB 2015; PCAOB 2017). Specifically, auditors are required to provide expanded audit reports (EARs), in which auditors must communicate with the public about key audit risks and how they address those risks. The EAR is intended to communicate more of the auditor's information to the users of the financial statements.[5] Previous studies, such as Burke et al. (2023), Gutierrez et al. (2018), Lennox et al. (2023), and Reid et al. (2019), have examined whether EAR can provide more information to the market or affect audit quality, but find mixed results.[6]

In this paper we examine the real effect of the EAR on a specific corporate misbehavior, i.e. RPTs. We argue that the EAR can have a significant reduction effect on firms' engagement in RPTs for the following reasons. First, standard setters suggest that RPTs are associated with greater risk of material misstatements (e.g., SAS No. 99; ISA No. 550) and RPTs often involve significant and complex auditor judgments. For example, it is difficult for auditors to assure that all aspects of an RPT are equivalent to those of a similar arm's length transaction. Therefore, RPTs are potential key audit matters that auditors need to communicate to the public in the EARs.

[4] Fang et al. (2018) find that auditors issue modified audit opinion with an explanatory paragraph to specifically discuss RPTs to communicate audit risk.

[5] The key audit risks are referred to as "risks of material misstatement" by the U.K. Financial Reporting Council, "key audit matters" by the IAASB, and "critical audit matters" by the PCAOB with similar meanings. We use them interchangeably in this paper. According to the IAASB, key audit matters are matters of the most significance for the audit of the current-period financial statements.

[6] See section 2.2 for detailed discussion of relevant literature.

Consistent with this argument, when explaining the rules used in the determination of key audit matters, the IAASB (2015) specifically mentions RPTs as an example (ISA 550, paragraph A 15). Second, expanded audit reports may change client firms' behavior due to the enhanced pressures from investors and other stakeholders. Therefore, for a given level of RPTs, firms' *expected costs* increase or *expected benefits* decrease after the implementation of expanded audit reports, which potentially affects their engagement in RPT activities.[7]

Our empirical analyses utilize regulatory changes in China that require auditors to adopt expanded audit reports. We use the Chinese setting for the following reasons. First, similar to many other emerging markets, listed firms in China often have concentrated ownership structures and therefore RPTs are widespread and economically meaningful. Studies document that RPTs in China are widely used by corporate insiders as tools for self-dealing purposes (e.g., Jiang, Lee, and Yue 2010). The significant volume of RPTs in China provides an opportunity to observe meaningful changes in RPT volume as a result of the new audit reporting regime. Second, in contrast to professional investors who can access information from other channels and have the capability to analyze complex information, nonprofessional investors are more likely increase their attention by the salient EARs so as to scrutinize the disclosed key audit matters. Because the Chinese stock market consists of a large number of retail investors, EARs are more likely to play a significant role.[8] Third, in China, all RPTs are required to be disclosed in the financial statements and accordingly fall under the responsibility scope of auditors. The uniform disclosure requirements and machine-readable RPT data also allow us to better identify the

[7] Note that this argument does not require that auditors actually discuss RPTs as a key audit matter. The threat of including RPTs in the audit report will make the expected costs of RPTs increase, which motivates firms to change behaviors.

[8] Yoon (2021) documents that on average retail investors contribute to 85%-90% of the daily trading volume in China.

effects of the EARs on RPTs.

Similar to other standard setters, the Chinese Institute of Certified Public Accountants (CICPA) issued Chinese Standard on Auditing (CSA) No. 1504 that requires auditors to communicate key audit risks in the EARs. The implementation schedule includes two phases: In the first phase, starting from fiscal year 2016, firms with stocks listed on both the Mainland China and Hong Kong exchanges (i.e., A+H firms) are required to provide expanded audit reports. In the second phase, firms with stocks listed only on the Mainland stock exchanges (i.e., A firms) are required to adopt starting from the 2017 fiscal year. This phased adoption allows us to employ a difference-in-differences research design for our analyses and to better identify the effects of expanded audit reports.[9]

For the primary analyses, we focus on the event when the first batch of firms adopted EAR. Our sample is from the period 2014-2016 and includes all Chinese firms listed on the Main board and SME board.[10] Around fiscal year 2016, the audit reports of A+H firms change from a binary model to the expanded model, while other firms still use the binary model. We use A+H firms as the treated sample and other firms as the control sample, and measure RPTs as the total related-party transactions deflated by total assets. Using a standard difference-in-differences (DID) model with firm fixed effects that control for any time-invariant (and unknown) firm characteristics, we find that A+H firms decrease their RPTs after the aoption of expanded audit reports compared to control firms. Because A+H firms have different firm characteristics than other firms, we also use propensity-score matched firms as the control sample and find consistent

[9] Because the EAR is "expanded" by including key audit matters as the public communication of audit risks, in this paper, we regard "the effect of EARs" as akin to "the effect of public communication of audit risks."
[10] The Main board and SME board are market segments of the stock exchanges in China. The Main board caters to large and established firms, and the SME board comprises small and medium sized firms.

results. The results are consistent with the idea that public communication of audit risks can constrain RPTs.

We argue that the underlying mechanism is that EARs can attract investors' scrutiny, thus increasing the potential penalty on self-dealing activities. This in turn pressures firms to reduce their RPTs. To provide evidence of this channel, we carry out the following tests. First, a starting point of our arguments is that EARs can attract greater investor scrutiny. To provide empirical evidence on this premise, we use the number of posts in online discussion forums and the number of internet searches as proxies for investor scrutiny. We find that both posts and internet searches increase after firms implemented EARs.

Second, if enhanced investor scrutiny leads to the observed reduction, then we expect that effects will be more pronounced when investor attention is more likely to be attracted by the EARs. We use a variety of proxies to measure the likelihood that investors's attention may be attracted, including the percentage of professional investors, the number of posts in online discussion forums, the number of internet searches, and the probability that firms will receive RPT related EARs. We divide the sample based on the likelihood that firms will receive attention and find stronger effects when firms are more likely to attract investors' attention.

Third, if the reduction of RPTs is due to firms responding to enhanced investor scrutiny, then we would expect firms that care less about investor scrutiny to respond less (i.e., we expected a more muted reduction in RPTs). In China, firms with political influence receive a variety of preferential treatments, such as preferential bank loans, favorable regulatory or court outcomes, etc. (e.g., Lee, Walker, and Zheng 2014; Ezzamel, Xiao, and Pan 2007). These firms care relatively less about the scrutiny of investors and other stakeholders. Consistent with this

argument, we find that the effects are weaker when firms are controlled by local governments or are particularly important for local governments. Taken together, these results provide supporting evidence for our arguments about the driving mechanism.

We conduct several additional analyses. First, RPTs may occur for both normal business and opportunistic purposes. We categorize RPTs as "Business" vs. "Non-Business" following Kohlbeck and Mayhew (2017) and Hope and Lu (2020). Our results show that the effects of EARs are concentrated in the Non-Business RPTs, which are more likely to reflect opportunism.

Second, starting from fiscal year 2017, all firms are required to provide expanded audit reports. Therefore, we treat 2017 as a second event. We employ A firms as the treatment firms that start to be required to provide expanded audit reports in 2017 (with A+H firms as control firms, which have already EARs in 2016 and do not change around 2017). We run similar DID models with firm fixed effects. Again, the evidence indicates that treatment firms decrease their RPTs after their auditors start to provide expanded audit reports.

Our study makes the following contributions. First, our paper adds to research on RPTs. RPTs are often opportunistically used for self-dealing purposes and regulators regard RPTs as a critical risk area for which they have issued new auditing rules (IAASB 2008; PCAOB 2014). Extant studies examine the effects of RPTs on different auditing attributes, such as audit fees or audit opinions (e.g., Kohlbeck and Mayhew 2017; Fang et al. 2018; Hope and Lu 2020). However, research on the role of auditors in shaping firms' engagements in RPTs is surprisingly limited given the long-standing awareness of the importance of RPT auditing among policy makers and the business community. Our study fills this gap and shows that public communication of critical audit risks to investors via EARs can effectively reduce RPTs,

especially opportunistic RPTs. More broadly, we add to the literature on the protection of minority shareholders by highlighting the auditor's role in constraining opportunistic RPTs (e.g., Djankov et al. 2008; OECD 2009; 2012).

Second, our research provides new evidence on the effects of a recent audit reform. Studies have examined whether the additional audit disclosures are informative to investors (e.g., Lennox, Schmidt, and Thompson 2023; Gutierrez et al. 2018; Burke et al. 2023). As the PCAOB (2017) suggests, the expanded audit reports may also have indirect effects by providing "some auditors, management, and audit committees with additional incentives to change their behavior." Our paper focuses on a specific corporate action and can thus provide stronger identification than looking at broader outcomes such as overall market reactions. Our results indicate that EARs can reduce firms' engagement in RPTs, supporting the idea that this audit reform has an impact on firms' *real activities*. Our article also identifies a mechanism through which EARs affect firms decisions - increased investor scrutiny. Our paper suggests a holistic perspective to evaluate the reform. More broadly, our study extends the prior literature on the *real effects of disclosure* (e.g., Graham, Harvey, and Rajgopal 2005; Leuz and Wysocki 2016) by showing the real effects of expanded disclosure issued by a third party instead of by management.

Finally, as the largest transitional economy with the second largest stock market, China attracts a growing base of global investors. Our paper sheds light on the effects of expanded audit reports, a worldwide reform in audit industry, in this market. Our findings also carry possible policy implications for regulators in emerging markets who intend to curb abusive RPTs and protect minority shareholders (OECD 2009; 2012).

2. Literature Review and Hypothesis Development

2.1. Related-Party Transactions

RPTs are transactions between a firm and related parties, such as subsidiaries, affiliated firms, principal shareholders, managers, and directors. RPTs are prevalent around the world.[11] Two different explanations for firms' engagement in RPTs have been put forth. The first is from the efficiency perspective ("efficient contracting"). Because information asymmetry is less severe between related parties, RPTs can be used to reduce transaction costs or increase contract efficiency. Studying the Indian market, Khanna and Palepu (2000) suggest that RPTs can be used as a way to optimize internal resource allocation, leading to a higher return on assets. Ryngaert and Thomas (2012) and Kohlbeck and Mayhew (2004) also suggest that certain types of RPTs can be beneficial for firms.

More studies take on an opportunistic perspective (or "private benefits of control"). That is, without an arm's length relationship between transactional parties, RPTs are often opportunistically used by corporate insiders for their own benefits (e.g., Hope, Lu, and Saiy 2019). La Porta, Lopez-de-Silanes, and Zamarripa (2003) examine related-party lending in Mexico and find that such lending carries lower interest rates and is more likely to default. Dahya, Dimitrov, and McConnell (2008) analyze a sample of 22 countries and document that firms with RPTs are associated with lower valuation. Jiang et al. (2010) report that controlling shareholders in China siphon company resources through inter-company loans, leading to significant wealth

[11] For example, Kohlbeck and Mayhew (2004) report that 63 percent of their S&P 1500 sample firms have RPTs. The OECD (2012) investigates 31 jurisdictions and documents the extensive prevalence of RPTs around the world.

loss among minority shareholders.[12] The OECD (2009) suggests that abusive RPTs are often accompanied by a misrepresentation of the financial situation and are one of the biggest corporate governance challenges in Asia. The OECD (2012) further investigates the experience of over 30 jurisdictions in managing RPTs and advocates curbing opportunistic RPTs to protect minority shareholders. The OECD regards the external auditor as an important power to fight abusive RPTs.

Researchers have long noticed the opportunistic role of RPTs and have associated RPTs with different aspects of auditing. For example, researchers link RPTs with higher misstatement risks (i.e. Beasley, et al. 2010; Beasley et al. 2001; Kohlbeck and Mayhew, 2017), with audit fees (i.e. Kohlbeck and Mayhew, 2017), and audit opinions (i.e. Jiang et al. 2010; Fang et al. 2018). However, research to date mainly focuses on the impact of RPTs on auditing, with far less research examining the *impact of auditing on RPTs*. This is surprising given the considerable awareness of auditors' role in affecting clients' RPT engagement from standard setters and practice. Bennouri et al. (2015) use data from France and report that firms with Big-4 auditors report fewer RPTs, suggesting that the auditor plays a monitoring role in RPTs. In this paper, we examine whether and how the regulatory changes to the audit report model, which improve auditors' communication of key audit matters to the public, affect firms' RPT activities.

2.2. The Expanded Audit Report

The traditional audit report is often viewed as a pass/fail document with limited communication of firm-specific auditing information (e.g., Mock, et al. 2013). Additional communication of auditors' professional judgment has the potential to be useful to the market.

[12] Although inter-company loans are now prohibited, Jiang and Kim (2020) suggest that tunneling still persist and RPTs are perhaps "the most common channel of minority shareholder expropriation" in China.

After the 2008 financial crisis, standard setters around the world started to reform the audit report model for financial statement audits. In response to the demand for more information, new auditing standards require an EAR (i.e., ISA 701; AS 3101), within which auditors are required to disclose additional information on matters that are important to users' understanding of audited financial statements (e.g., Mock et al. 2013). The EAR intends to enhance the informativeness of the auditor's report and the transparency of the audit procedures, and renew the focus of the auditor on critical matters that arise during the audit process (PCAOB 2017; IAASB 2015; Bédard et al. 2016).

Early EAR studies are mainly experimental and conclude that EAR provides additional information that can affect users' decisions.[13] Recent empirical archival studies, however, find mixed evidence. On one hand, Gutierrez et al. (2018) and Lennox et al. (2023) use the U.K. setting and find that EARs contain little incremental information. Liao et al. (2022) examine the Hong Kong setting, while Burke, et al. (2023) investigate the U.S. setting and both studies find little or no evidence that KAMs provide incremental information to investors or improve audit quality. On the other hand, Reid et al. (2019) reveal that EARs are associated with an improvement in financial reporting quality in the U.K. setting. Chen et al.(2020) find that textual features of EARs in Hong Kong are related to the pricing of audit services. Goh et al. (2022) observe increased earnings response coefficients and trading volume after the implementation of new EAR standards in China (particularly relevant to our setting). In addition, Porumb et al. (2021) find that the introduction of the expanded audit report is associated with improved lending terms for adopting relative to non- adopting firms. Drake et al. (2021) show that firms reduce

[13] See Bédard et al. (2016) for a summary of such studies.

tax-related earnings management following the tax-related CAM. Klevak et al. (2023) conclude that more extensive CAM disclosure is associated with higher risks.

Extant studies provide several reasons for the existence or non-existence of the additional information. Lennox et al. (2023) suggest that EARs in the U.K. may not provide incremental information because the information environment is already rich and disclosure about the risk of material misstatements could have already been made through other channels. Liao et al. (2022) suggest that KAMs could be informative for specific companies or could change the outcomes of a given audit engagement, even if the overall effects are insignificant. Burke et. al. (2023) find that, although on average CAMs are not associated with audit quality, several attributes of CAM disclosures are associated with variations in discretionary accruals, suggesting the importance of examining specific attributes of CAMs. Drake et al. (2021) suggest that focusing on one particular account is more powerful to identify the financial reporting outcomes associated with EARs. Goh et al. (2022) suggest that EARs may provide incremental information in emerging markets (and China in particular) where alternative public information channels are relatively scarce.

To summarize, research has mainly focused on whether the EAR can provide incremental information for investors or affect audit quality. However, as PCAOB (2017) suggests, the communication of risks may have indirect effects on firms (or "real effects") because managers know that "investors and the auditor will be scrutinizing more closely the matters identified as critical audit matters." Our motivation is consistent with this argument, and our study examines whether and how the EAR can affect client firms' *real activities*.[14] Unlike studies that look at

[14] A recent experimental study finds evidence consistent with the critical audit matter disclosure affecting operating decisions with respect to loan issuance and the use of derivatives (Bentley, Lambert, and Yang 2021).

broader outcomes such as overall market reactions, we examine a specific impact, that is, the reduction in RPT in relation to the EAR, which provides stronger identification. Further, by focusing on China setting where retail investors still dominate the market, our study complements Goh et al. (2022) and deepens our understanding of the effects of EARs in emerging markets.

2.3. Hypothesis Development

The audit report is the only channel through which auditors are able to directly communicate with the public (DeFond and Francis 2005; Anantharaman, Pittman, and Wans 2016). For a long time, the audit report followed a pass/fail model (i.e., the auditor issues either an unqualified or qualified opinion), and provided limited firm-specific information. The IAASB Consultation Paper (2011) suggests that this simplistic audit report model leads to an information gap between the information desired by users and the information available in the audit report.[15] The information conveyed by the audit report is viewed as so limited that most users do not read the audit report but only check whether it is qualified (Gray et al. 2011).

The simplistic model does not provide information about what areas of the audit involve significant professional judgment or audit difficulty. RPTs can be such an area for many firms for two reasons: First, firms may engage in RPTs for either legitimate or opportunistic reasons, and the latter relates to a higher risk of misstatements or accounting fraud (PCAOB 2014). However, it requires significant professional judgment for auditors to determine whether RPTs are opportunistic or not. Second, because RPTs are between related parties, the probability of

[15] Bédard et al. (2016) suggest that there are two information gaps: (1) The entity information gap, referring to the information about the entity and its financial statements; and (2) audit information gap, referring to the information about the audit performed.

collusion among transacting parties to manipulate the occurrence, pricing, and business purpose of the transaction is high. Therefore, auditors may have more difficulty obtaining relevant audit evidence, such as evidence that all other aspects of an RPT are equivalent to those of a similar arm's length transaction. In the period with a more simplistic model (i.e., pre-EAR period), auditors may issue a modified audit opinion with an explanatory paragraph to specifically discuss RPTs (Fang et al. 2018). However, the issuance of a modified opinion will impose significant costs on the client and may strain the auditor-client relationship. Thus, auditors may refrain from issuing a modified audit opinion for RPTs.

In recent years, standard setters have required auditors to disclose more information about audit risks. For example, ISA 701, issued by the IAASB in 2015, requires auditors to include a section to discuss key audit matters. Here, key audit matters are those matters that demand significant auditor attention in performing the audit, such as areas with higher assessed risk of material misstatements, areas requiring significant auditor judgment, or transactions or events that had a significant effect on the financial statements or the audit. Specifically, in the EAR, the auditors need to (1) disclose what are regarded as key audit matters; (2) discuss why the matter was considered to be of significance in the audit and therefore determined to be a key audit matter; (3) discuss how the matter was addressed in the audit; and (4) include a reference to the related disclosures, if any, in the financial statements.[16] IAS 701 states that the purpose of communicating key audit matters is to enhance the communicative value of the report by

[16] For example, auditors can discuss aspects of the auditor's response or approach that were most relevant to the matter or specific to the assessed risk of material misstatement, the audit procedures performed, the outcome of the auditor's procedures, or key observations with respect to the matter. The requirements of EARs are similar for other regulators. For example, ISA 700 (U.K. and Ireland) requires auditors to include (a) a description of risks of material misstatement which had the greatest effect on the overall audit strategy; the allocation of resources in the audit; (b) an explanation of how the auditor applied the concept of materiality; and (c) a summary of the audit scope, including an explanation of how the scope was responsive to the assessed risks of material misstatement described in (a) and the applied materiality as described in (b).

providing greater transparency about the audit engagement that was performed.

We believe EARs can have a significant impact on RPTs. First, RPTs are potential candidates for key audit matters to be included in EARs. ISA 701 lists several factors to be considered to determine key audit matters, such as areas with higher assessed risk of material misstatements, areas requiring significant auditor judgment, or transactions or events that had a significant effect on the financial statements or audit. RPTs represent greater risks of material misstatements (SAS No. 99; ISA No. 550). RPTs further involve difficult or complex auditor judgments because it is difficult for auditors to assure that all aspects of an RPT are equivalent to those of a similar arm's length transaction. Therefore, if RPTs are material, auditors are likely to choose them as key audit matters. In fact, ISA 701 lists RPTs as an example of key audit matters.[17] In our sample, we find that in 2016, 28% of A+H firms that adopted EARs have key audit matters related to RPTs (see Part B of Appendix C). Although in the pre-EAR period auditors could communicate the audit risk about RPTs through modified audit opinions, the adoption of EAR clearly reduces the threshold for an auditor to discuss RPTs.

Second, because RPTs may be identified as key audit matters and be discussed in EARs, engaging in RPTs will likely incur additional expected costs due to increased investor scrutiny. Although much of the information disclosed in EARs may be available through the analysis of notes, these key audit matters are disclosed in a more salient place and separated from the lengthy financial statements. Research suggests that investors have limited attention and are attracted by salient information (e.g., Hirshleifer and Teoh 2003; Huang, Nekrasov, and Teoh 2018), thus

[17] See the discussion in ISA 701 (IAASB 2015, A15). Note the determination is principles-based and does not specify that RPTs should always be a key audit matter. PCAOB (2017) does not specify any items that would always constitute a critical audit matter; however, it indicates that some commenters suggest to always identify all material RPTs as critical audit matters.

disclosures in EARs are likely to attract investor attention. Utilizing eye-tracking technology, Sirois, Bédard, and Bera (2018) find that key audit matters have an impact on investor attention. Further, key audit matters are disclosed by a third party other than management, and thus are regarded as more credible. Because information from more credible sources draw more attention (e.g., Pornpitakpan 2004), the communication of audit risks may increase investor (and other stakeholder) attention, leading them to scrutinize and potentially apply penalties for firms that engage in RPTs, especially the opportunistic RPTs. Goh et al. (2022) find that in China, trading volumes increase after firms issued EARs, suggesting that investors pay attention to the additional disclosure.[18] Expecting the increased costs associated with RPTs, firms are likely to become more cautious in engaging in RPTs to avoid being discussed in the audit report. Our arguments pertain to the overall expected costs of RPTs rather than the explicit mention within the EAR of RPTs. The above arguments lead to our hypothesis:

H1: **Firms reduce related-party transactions after the adoption of the expanded audit report.**

Note that auditors cannot decide whether a company can or cannot enter into an RPT (e.g., Kohlbeck and Mayhew 2017). The regulatory change only affects the disclosure of audit risks in the audit report, which does not directly address RPTs. Therefore, whether firms change their RPTs behavior in response to the EAR is an empirical question.

[18] Their finding that investors care about EARs in China is important, as it suggests that EARs may discipline managers through the market. In untabulated results, we also find significant negative market reactions when firms receive RPT related EARs. In Section 5.3 we provide more direct evidence that investors increase scrutiny after EARs are adopted.

3. Sample and Research Design

3.1. Sample Selection

We use regulatory changes in China to test our hypothesis. Following the worldwide reform trend, the China Securities Regulatory Committee started to implement the audit rule requiring EARs. The specific audit rule CSA No. 1504, titled "Communicating Key Audit Matters in the Independent Auditor's Report," is very similar to ISA 701 and requires auditors to include one section to communicate key audit risks in the audit report. The rule is effective in two phases: A+H firms start from fiscal year 2016, and A firms start from fiscal year 2017.[19,20]

Our primary analysis focus on the event when A+H firms adopted EAR, and use a sample spans from year 2014 to 2016. We obtain RPT data and other main firm-level characteristics from the China Stock Market and Accounting Research (CSMAR) database. We start our sample with all firms listed on the Shanghai and Shenzhen stock exchanges in China. After deleting firms with only B shares, listed on the ChiNext board, and firms with negative equity or missing information, we are left with 4,515 firm-year observations.[21] All continuous variables are winsorized at the 1st and 99th percentiles in order to mitigate the potential effects of outliers.

3.2. Research Design

Exploiting the phased adoption of the new standard, we utilize a standard difference-in-

[19] A+H firms are cross-listed on the Hong Kong exchange. As the Hong Kong exchange required EARs in year 2016, probably to be consistent, China Security Regulatory Commission also required these firms to adopt EARs since 2016.

[20] The CSA 1504 was officially issued in 2016. However, A+H firms likely expected the requirement earlier. For example, in August 2015, the Hong Kong Stock Exchange issued HKSA 701 and required firms with H shares to provide EARs starting from fiscal year 2016. Further, because Hong Kong auditing standards closely follow international auditing standards, firms likely anticipated the rules when the similar ISA701 was issued by IFAC in January of 2015. With the perception that new rules may lead to increased investor scrutiny on self-dealing activities, managers will reduce RPTs to avoid KAM discussion

[21] B shares are traded in foreign currencies and are mainly traded by foreign investors. Our sample does not include firms listed on ChiNext, which is established to attract innovative and fast-growing enterprises, especially high-tech firms. The listing standards of ChiNext are less stringent than those of the Main and SME Boards.

differences model to examine the effects of the EAR on RPTs:

$$RPT = \beta_1 TREAT \times POST + Controls_{i,t} + Fixed\ Effects + \varepsilon \quad (1)$$

Following Fisman and Wang (2010), we measure the dependent variable (*RPT*) as the value of RPTs scaled by total assets, which captures the economic importance of RPTs.[22] *TREAT* is an indicator variable which equals 1 for A+H firm, and 0 for other firms; *POST* is an indicator variable which equals 1 for year 2016 and equals 0 for year 2014 and 2015. Our test variable is *TREAT*×*POST*. The coefficient on the interaction term, β_1, captures the incremental change in RPTs from the pre- to the post-period for A+H firms compared with A firms. We expect a negative coefficient on β_1, which indicates that adopting EARs constrains firms' engagement in RPTs. Because both firm fiexed effects and year fixed effects are included, *TREAT* and *POST* are subsumed.

We include variables that may affect RPTs as controls following previous studies (e.g., Kohlbeck and Mayhew 2017; Balsam, Gifford, and Puthenpurackal 2017): firm size (*SIZE*), leverage ratio (*LEV*), return on asset (*ROA*), market-to-book ratio (*MB*), executive compensation (*COMPENSATION*), firm age (*AGE*), and R&D expense (*RD*).

Research indicates that corporate governance affects RPTs (Balsam et al. 2017); therefore, we also control for board independence (*INDDIR*), CEO tenure (*TENURE*), and insider ownership (*INSIDER*) and the percentage of shares held by the largest shareholder (*CONCENTRATION*). Next, we include a set of variables to control for external monitoring (e.g., Jiang et al. 2010). Specifically, we include Big-4 auditor (*BIG4)* and analyst coverage (*ANALYST*) in our model. We cluster standard errors at the firm level to mitigate the potential overstatement

[22] In robustness tests, we also use the number of RPTs and find consistent results.

of statistical significance owing to serial correlation in the error term (Petersen 2009). All variable definitions are provided in Appendix A.

Sample firms adopted EARs in two batches. Because the first batch of firms (A+H firms) are quite different from the second batch of firms (A firms), to mitigate the possibility that our results are driven by inherent differences between A+H firms and A firms, we also employ PSM to generate a group of A firms so that these two batches of firms are similar (e.g., Dehejia and Wahba 2002).[23] The detailed procedures to generate the PSM matching sample are provided in Appendix B.[24] Our PSM sample includes 83 pairs of A+H firms and A firms.

Table 1 provides descriptive statistics for our sample. In Panel A, we present firm characteristics in year 2015 (i.e., the year before the event) for treatment sample, control sample using all A firms, and PSM control sample. We can observe that firm characteristics differ significantly in the treatment sample and the control firms using all A firms, which highlights the importance of using a matched control sample. None of the firm characteristics differ significantly in the treatment sample and the PSM control sample, indicating that our PSM matching is effective. In Panel B, we present firm characteristics for our main sample, which include treatment firms and PSM firms during the period of year 2014 to 2016. We have a total of 486 observations from 83 pairs of treatment firms and control firms.[25] We find RPT has a mean of 0.286, indicating the widespread usage of RPTs in China. Actually, 98.4% of observations in our sample have at least one RPT.

[23] Specifically, A+H firms are larger and followed by more analysts, have higher leverage ratio, have lower market-to book ratios, have lower incidence of CEO duality, and locate in more developed regions, etc.
[24] As there is no theoretical guidance on the selection of variables, our PSM is only as good as the variables included in the PSM model.
[25] Because some firms have missing information, the number of total observation is less than 498 (i.e., 83×2×3 years).

4. Main Results

4.1 RPTs as Key Audit Matter

Before proceeding to test our hypothesis, we conduct a preliminary investigation on RPT-related key audit matters. For treatment fims, we collect their sections of key audit matters in the first year of adoption. We manually read through the key audit matters and categorize them according to related accounting issues.[26]

We present three examples of firms identifying and discussing RPTs as key audit matters in Part A of Appendix C. We note three points from reading these discussions: (1) Because RPTs are defined according to the relationship of transacting parties, the discussion of RPTs may relate to different types of accounting issues, such as related sales, provisions of receivables, or asset transactions, etc. (2) The details of discussions vary significantly. (3) The report often refers to specific notes of the financial statements.

Panel B of Appendix C presents the distribution of key audit matters. There are a total of 93 EARs issued by A+H firms in 2016 financial reports and 26 (or 27.96%) of them discuss an issue involving RPTs.[27] This percentage is relatively high, which supports our argument that RPTs are one of the potential candidates for key audit matters. We also employ a probit

[26] Because RPTs are defined according to the transactional counterparties, the title of key audit matters may not correctly indicate whether the accounting issue involves a related party. For example, COSCO SHIPPING (601919.SH; 1919.H) has listed one key audit matter as "Asset Restructuring." However, detailed information reveals that this asset restructuring involves a series of interrelated transactions with related parties, such as COSCO Group and China Shipping Group. We therefore classify this key audit matter as both "Related Party Transactions" and "Major Asset Restructuring." This example suggests that a method using only titles to identify RPT-related key audit matters is likely to be inaccurate.

[27] There are a total 94 A+H firms, and one firm received a "disclaimer of opinion" thus had no EARs. Our inferences are not affected by the inclusion or exclusion of this firm. The number of A+H firms in year 2016 is larger than that used in PSM model because some firms do not have necessary information for PSM or have no appropriate matching firms.

regression to examine the relation between the magnitude of RPTs and the RPT-related key audit matter.[28] We find that a high value of RPTs significantly increases the possibility of auditors discussing RPTs as a key audit matter. This finding is consistent with the idea that material RPTs are associated with material audit risks (see ISA 701; Burke et al. 2023).

4.2 The Effects of EAR on Firms' Engagement in RPTs

Table 2 Panel A provides our main results from the estimation of equation (1). All regressions include year fixed effects and firm fixed effects. The year fixed effects control for any unobserved heterogeneity that varies across time, and the firm fixed effects control for any time-invariant (and unknown) firm characteristics. First, we use all other A firms as control sample ("full sample"). The estimated coefficient on TREAT×POST is -0.0529, which is significant at the 5% level (using two-sided tests). The evidence suggests that after auditors can communicate audit risks with the public in audit reports, A+H firms significantly decrease their engagement in RPTs compared to other firms that have not adopted the EAR rule. We then use the matched firms as control sample ("PSM sample") to test our hypothesis. The coefficients on TREAT×POST is -0.0803, which is also significant at 5%. Considering the mean of RPT in the PSM sample is 0.286, the coefficient suggests that a 28% decrease of RPTs for treatment firms after the adoption of EAR compared to the PSM firms. Because treatment firms and other A firms differ significantly in firm characteristics as shown in Table 1, which may introduce noise to the empirical results, we use the PSM sample in the following analyses. In Table 2 Panel B, we examine the time trend of the RPTs around the adoption of EAR rules. We find that the difference in RPTs between A+H firms and PSM firms is not

[28] Results are untabulated and are available if requested.

significant before A+H firms adopted EAR rules, becomes significant when A+H firms adopted EAR rules, and becomes insignificant again after A firms also adopted EAR rule.

In summary, the results from Table 2 provide support for our hypothesis. Because the EAR requires auditors to communicate audit risks with the public, the expected costs associated with RPTs increase, which leads firms to engage in fewer RPTs. The evidence supports the idea that the EAR potentially has the indirect benefit of constraining firms' opportunistic use of RPTs. [29]

5. The Mechanism

In this section, we examine a potential mechanism of the observed economic effects. According to our arguments above, the driving mechanism is as follows: EARs can attract investor scrutiny, which can increase the possible penalty associated with RPTs. Firms that expect such increased pressure in turn reduce their RPTs. We design our tests based on this framework.

5.1.Do EARs Attract Greater Investor Scrutiny?

The starting point of our proposed mechanism is that EARs increase the scrutiny of investors. In an experimental study, Sirois et al. (2018) use eye-tracking technology and find that key audit matters direct users' attention to the information highlighted by the auditor. To provide supporting empirical evidence, we design a direct test to examine whether investor scrutiny increases after the adoption of EARs. Following the literature, we use two proxies for investor

[29] Following studies that focus on China (Fang et al. 2018; Hope, Yue, and Zhong 2020), we include more China-specific control variables, such as an indicator for state ownership (SOE), an indicator for central government ownership (CENTRAL), the separation of ownership and control (SEPARATION), and the measure of market development (MARKETIZATION). We find that these additional control variables do not affect our inferences (untabulated).

scrutiny. The first is the number of posts in the first and most popular stock message board in China, EastMoney (Guba.Eastmoney.com). Each listed firm in China has a firm-specific stock message board on EastMoney. These posts are mainly created by small or retail investors (Hong, Jiang, Wang, and Zhao 2014; Ang et al. 2020). The second proxy is the number of internet searches for the firm. Previous studies use Google searches to measure investor attention (e.g., Da, Engelberg, and Gao 2011). In China, Google is blocked; thus, we use search data from the largest search engine, Baidu.com.[30] We use stock codes, firm names, or firm name abbreviations as the search keywords. For both proxies, we count the number of posts and internet searches made in the four weeks following the issuance of annual reports, and use the natural logarithm of the numbers in the regressions. The more posts or internet searches, the greater the investor scrutiny.

We regress the degress of investor scrutiny on *TREAT*×*POST* and other control variables. Following previous studies (e.g., Da et al. 2011; Drake, Roulstone and Thornock 2012; Ang et. al. 2020), we include the following control variables: firm size (*SIZE*), leverage ratio (*LEV*), market-to-book ratio (*MB*), analyst following (*ANALYST*), media coverage (*MEDIA*), advertising expenses (*ADVERTISING*), stock turnover (*TURNOVER*), abnormal stock return (*RETURN*), bid-ask spread (*SPREAD*), and institutional holdings (*INSTITUTION*). We also include *RPT* as a control variable. The results are presented in Table 3. The coefficients of *TREAT*×*POST* are significantly positive in both regressions, suggesting that investor scrutiny has increased after the adoption of EARs.

[30] Baidu has about 70% of the search-engine market share in China. See https://gs.statcounter.com/search-engine-market-share/all/china.

5.2. Does Increased Investor Scrutiny Lead to RPT Reduction?

We argue that increased investor scrutiny leads to RPT reduction. If this argument is valid, then the extent to which EARs can attract investor attention will determine the strength of the effects. To examine whether this is valid, we use a variety of proxies to measure the extent to which EARs can attract investor attention.

Our first measure is the percentage of shares held by professional investors in the firm. The literature suggests that, relative to professional investors, nonprofessional investors are more likely to be affected by EARs. Although EARs include discussions of key audit matters, much of the information has been disclosed through other channels (Lennox et al. 2023). Professional investors have more channels to collect information and are better able to analyze complex information, therefore they may not find the additional disclosures in EARs to be useful. By contrast, nonprofessional investors rely on fewer information channels and have weaker information analysis skills; thus, they may find the EARs more useful. Further, key audit matters are disclosed in a salient manner and are separated from the lengthy financial statements, which means they are more likely to attract the attention of retail investors. Huang et al. (2018) find that high salience is associated with stronger announcement reaction. Blankespoor, deHaan, and Zhu (2018) find that retail investors increase their trading activities after firms use "robo-journalism" because these articles catch their attention. Thus, EARs of firms with lower percentage of professional investors are more likely to draw investors' attention. We define professional investors as mutual funds, security companies, QFII (i.e., Qualified Foreign Investors), and other financial institutions.

Second, we use the the number of posts in stock message board and the number of internet

searches. Firms with more posts and more internet searches suggest that investors pay more attention to these firms thus will scrutinize their disclosure. Consistent with the last section, we count the number of posts and internet searches made in the four weeks following the issuance of annual reports.

Third, firms that receive RPTs related EARs are more likely to attract investors' attention to RPT issue. To estimate the likelihood of discussing RPTs in EAR, we construct a prediction model. Following Fang et al. (2018) and Burke et al. (2023), we include the following explanatory variables: six categories of RPTs (sales and purchases of goods/service, sales and purchases of assets/equity, intercorporate lending and borrowing), firm size, financial leverage, return on assets, Big 4 auditor, an indicator for negative income, restatement disclosure and marketization index.

To execute the empirical tests, we partition the sample based on each of the above proxies, and then run the regression as described in equation (1) using the PSM sample with year and firm fixed effects.[31] The results are shown in Table 4. In panel A, we use the percentage of professional investors as the partition variable. We find that the coefficient of *TREAT×POST is significantly* negative (insignificant) in the subsample where firms have a low (high) percentage of professional investors. Also, the difference in coefficients between the two subsamples is significant.

We execute similar tests using the other three proxies and present the results in Panel B (partition on message board posts), Panel C (partition on internet search), and Panel D (partition

[31] The grouping procedure is as follows: First, we divide the treatment firms into two groups according to the median of a specific characteristic. Second, each control firm is assigned to the same group as the matched treatment firm. This procedure assures that a treatment firm and its matched firm are included in the same sub-sample.

on the probability of receiving RPT-related EARs). In all these Panels, we find that the reduction effect of EAR on RPTs mainly exist when firms are more likely to attract investors' attention.

To summarize, the results strongly support our arguments that when firms are more likely to attract investors' attention and scrutiny, the expected costs of RPTs will increase more, which leads firms to reduce more RPTs.

5.3. Do Firms Respond to Increased Scrutiny?

A key part of our arguments is that firms will respond to increased investor scrutiny. However, not all firms are equally likely to respond to investor scrutiny. In particular, in China, firms with political influence are less likely to do so. First, more scrutiny implies that investors are more likely to identify self-dealing activities and penalize those firms by "voting with their feet." Expecting this behavior, firms may reduce their self-dealing activities. However, firms with political influence are less concerned about their market performance because they receive preferential financing treatment and rely relatively less on the stock market for external financing (e.g., Piotroski and Zhang 2014; Claessens, Feijen, and Laeven 2008).

Second, investors may share information and criticize self-dealing activities on social media (Ang et al. 2020). Yang (2020) finds that media coverage is positively associated with regulatory actions. Therefore, firms may worry about regulatory actions and reduce RPTs. However, firms with political influence are more likely to receive favorable regulatory or court outcomes (Lu, Pan, and Zhang 2015), and are therefore less affected by investor scrutiny.

Because firms with political influence care less about investor scrutiny, if the proposed mechanism is valid, we expect that the reduction effects of EARs will be weaker for firms with political influence. We examine this hypothesis using two measures of political influence. The

first is an indicator variable for whether the firm is controlled by the local government or not. The second is the importance of the firm in providing local employment opportunities, measured as the number of employees of the firm divided by the sum of the number of employees of all firms headquartered in the same province. Because the local government cares about the local unemployment ratio, firms hiring more local employees are important to the government and have the ability to exercise governmental power (World Bank 2013).

We partition the PSM sample into two sub-samples according to whether the firm is controlled by the local government or whether the firm is important for local employment. The results are presented in Table 5. We find that *TREAT×POST* is significantly negative when the firm is not controlled by the local government and when the importance for local employment is low. In contrast, *TREAT×POST* is insignificant when the firm is controlled by the local government and when the importance for local employment is high. In addition, the differences in coefficients between the more versus less politically influential groups are significant.

To summarize, our empirical results support our arguments about a likely driving mechanism: EARs can increase investor scrutiny and increase the possible penalty on self-dealing activities. In response to the increased scrutiny, firms reduce their RPTs.

6. Further Investigation

6.1. The Purpose of RPTs

RPTs may occur for both efficient-contracting purposes and for opportunistic purposes. RPTs with legitimate purposes can benefit the firm by reducing transaction costs and improving operational efficiency, while RPTs with opportunistic purposes are associated with significant

misstatement risks. According to our arguments, the opportunistic RPTs are the transactions that investors need to scrutinize and penalize.[32] Therefore, our arguments imply that EARs should have stronger effects on opportunistic RPTs.

Although it is difficult to distinguish the motivation behind RPTs, we follow Kohlbeck and Mayhew (2017) and categorize RPTs as "Business" vs. "Non-Business." Business RPTs are closer to the firm's core business operations and are more likely to be legitimate, while non-Business RPTs are more likely to be opportunistic and to suggest firms are open to self-dealing transactions. We use Business RPTs and Non-Business RPTs as dependent variables and re-run the regressions in Equation (1) using the PSM samples. Untabulated results show that the coefficient on *TREAT×POST* is significantly negative only for Non-Business RPTs. The evidence is consistent with the public communication of audit risks playing an active role in constraining opportunistic RPTs.

6.2. The Second Event

Second, we use the second phase as another shock and test our hypothesis. The regulator requires all other firms to provide EARs starting from fiscal year 2017. We use this event and run a similar regression as in Equation (1). Here, fiscal year 2017 is the event year. Around this event, A firms are treatment firms (TREAT2=1) that changed their audit report model, while A+H firms are control firms (TREAT2=0) that have already adopted EARs in 2016 and continue to use it in 2017. We use the sample period of 2016-2018. POST2 equals 0 for fiscal year 2016, and equals to 1 for 2017 and 2018.

[32] Note that, although we expect the effects to be greater for opportunistic than other RPTs, there are reasons why the EAR may affect all types of RPTs. Most importantly, it is difficult for auditors and investors to discern whether some RPTs are opportunistic or not. In such cases they are likely to treat all RPTs as the same. As a result, such "pooling" also increases managers' cost of using legitimate RPTs.

Similar to the previous tests, we use the same PSM sample that we have constructed for the analysis of phase 1.[33] In untabulated results, we find that the coefficients of TREAT2×POST2 is negative and significant, suggesting that A firms decrease RPTs after adopting EAR, compared to A+H firms. The evidence is consistent with the notion that public communication of audit risks leads firms to reduce RPTs.

6.3. When RPT Are Discussed

The hypothesis does not require that auditors actually discuss RPTs as a key audit matter. As we argue above, the *threat* of including RPTs in the audit report will make the expected costs of RPTs increase, which can motivate firms to change behaviors. However, it is interesting to examine whether firms will react after receiving EAR with discussion of RPTs. We empirically test this by focusing on the first batch of adopters. We use the change in RPTs from 2016 to 2017 as dependent variable. The variable of interest, *RPTEAR*, is an indicator variable that equals 1 if the firm received an RPT-related EAR in 2016, and 0 otherwise. We also include control variables in changes (i.e., year 2017 minus 2016). In untabulated results, we find that firms *reduce* their RPTs after receiving EAR with discussion of RPTs, suggesting that the adoption of EAR constrains RPTs. We also examine whether a specific *type* of RPT (i.e., goods transactions or asset transactions) is reduced after receiving EAR that discussed that type of RPT, and find consistent results.

7. Conclusion

In this paper, we examine whether public communication of audit risks in the expanded

[33] Note that this PSM sample is designed to test the change around phase 1, and is constructed by choosing A firms to PSM match A+H firms using the information in fiscal year 2015.

audit report impacts related-party transactions by client firms. RPTs can be opportunistically used by corporate insiders for self-dealing purposes and have been shown to be associated with risks of material misstatements. Using a sample of Chinese firms and employing a difference-in-differences approach with matching and firm fixed effects, we find that firms reduce their RPTs after the regulator implements new rules to require expanded audit reports. We argue that the driving mechanism is that EARs attract the scrutiny of investors, especially nonprofessional investors. Expecting the enhanced scrutiny, firms reduce their self-dealing activities. We provide evidence consistent with this channel. Further investigations show that the effect is stronger when RPTs are more likely to represent opportunistic behaviors. Our evidence highlights the important role of expanded audit communication in the largest emerging market.

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Appendix A: Variable Definitions

Variables	Definitions
RPT	The value of RPTs scaled by total assets (*Source:* CSMAR)
TREAT	Indicator variable for early adopters of expanded audit report, equal to 1 for A+H firms, and 0 otherwise
POST	Indicator variable for post-requirement period, which equals to 1 for year 2016, and 0 for years 2014-2015
SIZE	Firm size, calculated as the natural logarithm of firm's total assets at year end
LEV	Leverage ratio, calculated as total liabilities divided by total assets.
ROA	Return on assets, calculated as net income before extraordinary items divided by total asset
MB	Market-to-book ratio, calculated as total assets minus book equity plus market equity, divided by total assets at the year end
ANALYSTS	Analyst following, calculated as the natural logarithm of one plus the number of analyst reports on the firm
COMPENSATION	Executive compensation, calculated as the natural logarithm of the sum of the top three executives' compensation
INDDIR	The percentage of independent directors, calculated as the number of independent directors as a percentage of the total number of board directors
INSIDER	Insider shareholding, measured as the percentage of shares owned by the management (%)
BIG4	Indicator variable for Big-4 auditor, equal to 1 if the firm is audited by the Big-4 auditors, and 0 otherwise
AGE	Firm age, calculated as the natural logarithm of one plus the number of months that the firm has been listed
RD	The natural logarithm of one plus research and development expenditures
CONCENTRATION	The percentage of shares held by the largest shareholder
TENURE	CEO tenure, calculated as the natural logarithm of one plus the number of years the current CEO has been in office

Note: All variables are constructed using information from the CSMAR database.

Appendix B: Procedure to Construct the Propensity-Score-Matched Sample

	Dependent Variable =A+H Indicator	
VARIABLES	Coefficient	z-stat
SIZE	1.1165***	(6.60)
LEV	-2.8348***	(-2.70)
ROA	-10.2733***	(-3.89)
MB	0.1432	(1.25)
ANALYST	-0.0533	(-0.36)
COMPENSATION	0.3802*	(1.86)
INDDIR	-0.8343	(-0.32)
INSIDER	-0.0149	(-0.77)
BIG4	1.7377***	(5.38)
AGE	-0.0473	(-0.24)
RD	0.0173	(1.01)
CONCENTRATION	1.9039**	(2.35)
TENURE	0.0761	(0.43)
Constant	-34.6959***	(-7.42)
Observations	2152	
Pseudo R^2	0.470	

Notes: The PSM approach involves pairing treatment and comparison units that are similar in terms of their observable characteristics (Dehejia and Wahba 2002). We implement this procedure by first estimating a logit regression to model the probability of being A+H firms using the information from the last year before the EAR adoption (i.e., 2015). We use all of the control variables in Equation (1) as our predictors. The table presents the results from the logit model. *, **, *** indicate statistical significance at the 10 percent, 5 percent, and 1 percent levels, respectively. Next, we estimate the propensity score for each firm using the predicted probabilities from the logit model, and match each A+H firm to A firm using the nearest neighborhood technique with no replacement. Our PSM sample include 83 pairs of A+H firms and A firms.

Appendix C: The Categories and Examples of Key Audit Matters

Part A: Three Examples of Key Audit Matters in Year 2016

1. Luoyang Glass: 600876 (A share code) 1108 (H share code)

Key audit matters: Related Party Transactions

During the year of 2016, the income after tax from the product sales of the Company to the related party, Anhui Bengbu Huayi Conductive Film Glass Co., Ltd., was RMB 85,980,000, accounting for 22% of the total operating revenue, which recorded a significant increase compared to that of last period and had a significant impact on the net profit of this year. Since the truthfulness of related transactions and the fairness of transactions' prices have a significant impact on the fair presentation of the financial statement, we're of the view that **related transactions** of the Company are very important to the audit.

The audit procedures we performed mainly include: examination of agreements, goods delivery notes, sales invoices, sales collection voucher and others, and verifying if related transactions had truly occurred through the procedures including confirmation and monitoring method, judgment of the fairness of those transaction prices by comparison of sales prices to related parties with that of similar products to non-related parties or market prices of similar products, understanding the necessity and fairness of related transactions by onsite visiting and interviewing the related clients.

2. GUANGSHEN RAILWAY：601333 (A Share code) 0525 (H Share code)

Key audit matters: Provision for impairment of trade receivables

Refer to notes 4 and 18 to the consolidated financial statements. As of 31 December 2016, the gross trade receivables of the Group were approximately RMB3,369 million including balances aged more than one year of approximately RMB847 million, which were assessed by the management of the Company as past due but not yet impaired.

The majority of the trade receivables were due from **related parties** of the Group, other state-owned railroad companies or companies in the transportation industry. A provision for impairment of trade receivables amounting to RMB5 million had been recorded thereon. Impairment provision of trade receivables is made based on an assessment of the recoverability of the amounts. Provision for impairment of trade receivables involves management judgment and the actual outcome may be different from original estimation.

We focused on this area because of the significance of the gross trade receivables to the consolidated financial statements and the estimation and judgment involved in the determination of the recoverability of these trade receivables.

We have performed the following procedures to address this key audit matter:

(i) We understood, evaluated and validated the key controls relating to management assessment performed on of the recoverability of the trade receivables, including aging analysis review and regular assessment performed on collectability of the receivable balances;

(ii) We sent audit confirmation on major balances and also on certain small balances outstanding at year end.

(iii) We tested the accuracy of aging analysis of receivable balances prepared by management on a sample basis;

(iv) We obtained management's assessment on the collectability of individual significant outstanding balances, focusing on those aged more than one year. We corroborated management's assessment against available evidence, including searching customers' background, reviewing current operational and cash flow status; and their historical transactions enacted with the Group and the respective collection pattern etc.;

(v) For those items with impairment provision being made, we corroborated management's assessment against evidence of significant financial difficulties encountered by the customers and we checked the mathematical accuracy of the impairment charge calculations. We also verified the third party evidence which demonstrates the Group no longer possess the right to recover the outstanding balance to corroborate the trade receivables being written off.

Based on the work performed, we considered management's judgments made in relation to the impairment assessment of trade receivables were supported by the evidence we obtained.

3. COSCO SHIPPING：601919 (A share code) 1919 (H share code)

Key audit matters: Asset restructuring with COSCO Group and China Shipping Group, Refer to notes 1, 2(b)(i), 36 and 40 to the consolidated financial statements

On 1 February 2016, the shareholders of the Company approved in the extraordinary general meeting several proposed major and connected transactions in connection with the asset restructuring with COSCO Group and China Shipping Group (the "Asset Restructuring"). The Asset Restructuring comprised:

(1) the disposals of China COSCO Bulk Shipping (Group) Co., Ltd. ("COSCO Bulk") and Florens Container Holdings Limited ("FCHL") to COSCO Group and China Shipping Group respectively (the "Disposal Transactions");

(2) the acquisitions of certain agency companies and China Shipping Ports Development Co., Limited (together the "Acquired Entities") from COSCO Group and China Shipping Group (the "Acquisition Transactions"); and

(3) the leasing of containers and container vessels from COSCO SHIPPING Development Co., Ltd. ("CSDL"), a subsidiary of China Shipping Group (the "Leasing Transactions").

We have identified the Asset Restructuring with COSCO Group and China Shipping Group as a key audit matter because of its financial significance to the consolidated financial statements and because the Transactions comprised a series of **interrelated transactions with related parties** which significantly affected the composition of the Group's businesses and activities, and also its related audit risk areas. Significant audit effort is required. Disposal Transactions The Group recorded a loss of RMB2,430 million from the disposals of COSCO Bulk and FCHL. Details of the calculation of the loss is disclosed in note 36 to the Group's consolidated financial statements.

Acquisition Transactions

The Acquisition Transactions have been accounted for in the consolidated financial statements as business combinations under common control using merger accounting as the Group and

China Shipping Group are under the common control of the State-owned Assets Supervision and Administration Commission of State Council of the People's Republic of China.

Details of the merger accounting method for common control combinations are disclosed in note 2(b)(i) to the consolidated financial statements. Statement of adjustments for the Acquisition Transactions are disclosed in note 40 to the consolidated financial statements.

Our procedures in relation to the Asset Restructuring included the following:
• participated in various meetings and discussions with external professional parties appointed by the Group and Group's management.
• obtained and read the related share purchase agreements, lease agreements and related announcements made by the Group to assess the implications of these various transactions to the Group's consolidated financial statements.
• checked the consideration paid and received by the Group to bank statements. Disposal Transactions
• tested the accuracy of the assets and liabilities of COSCO Bulk and FCHL, which were included in the calculation of the Loss on Disposal and related results disclosed within discontinued operations, by reconciling these amounts to the completion financial statements of these disposed groups.

Acquisition Transactions
• assessed if the Acquisition Transactions fulfilled the requirements of business combinations under common control for applying merger accounting.
• compared the accounting policies of the Acquired Entities against the Group's accounting policies and assessed the adjustments made to achieve consistency.
• checked the intercompany balances and transactions between the Acquired Entities and the Group to assess the accuracy and completeness of the elimination adjustments.
• reconciled the relevant historical carrying values of the assets and liabilities of the Acquired Entities to the historical audited financial statements of the respective entities.
• tested balances of the assets and liabilities as at 1 January 2015 and 31 December 2015 and the financial performance and cash flows for the year ended 31 December 2015 of the Acquired Entities included in the consolidated financial statements under merger accounting to assess their accuracy.

Leasing Transactions
• checked and considered the key terms and arrangements in the agreements by assessing the key terms and arrangements in the agreements against the lease classifications indicators.

Based on the audit procedures performed, the accounting of the Asset Restructuring was supportable by the available evidence.

Part B: Categories of Key Audit Matters in Year 2016

	N of Firms	Percentage
Asset Impairment	79	84.95%
Revenue Recognition	28	30.11%
Related Party Transactions	26	27.96%
The Scope of Consolidation	20	21.51%
Fair Value Measurements	15	16.13%
Liability / Contingent Liability	12	12.90%
Major Asset Restructuring	10	10.75%
Taxation	8	8.60%
Depreciation and Amortization	6	6.45%
Others	13	13.98%

Note: A total of 93 A+H firms disclosed key audit matters in fiscal year 2016. The categories above are based on a detailed reading of the financial reports.

Table 1: Descriptive Statistics

Panel A Comparison between Treated Firms and Control Firms before the Event

		No PSM		PSM	
VARIABLE	Treat	Control	Difference (Treat-Control)	Control	Difference (Treat-Control)
SIZE	25.1365	22.3012	*2.8353***	24.7846	*0.3519*
LEV	0.6437	0.4566	*0.1871***	0.6448	*-0.0011*
ROA	0.0210	0.0313	*-0.0103*	0.0138	*0.0072*
MB	1.7294	3.7317	*-2.0023***	1.8196	*-0.0902*
ANALYST	2.8326	1.7976	*1.035***	2.6137	*0.2189*
COMPENSATION	16.1560	15.2433	*0.9127***	16.1855	*-0.0295*
INDDIR	0.3832	0.3741	*0.0091*	0.3828	*0.0004*
INSIDER	1.5138	9.8009	*-8.2871***	1.6971	*-0.1833*
BIG4	0.6265	0.0504	*0.5761***	0.5542	*0.0723*
AGE	4.8121	4.6632	*0.1489*	4.8142	*-0.0021*
RD	12.2262	13.1906	*-0.9644*	13.2863	*-1.0601*
CONCENTRATION	0.3534	0.2426	*0.1108***	0.3379	*0.0155*
TENURE	1.0673	1.0644	*0.0029*	1.1163	*-0.049*

Panel B Descriptive Statistics for Main Variables for the PSM Sample

	N	MEAN	SD	P25	P50	P75
RPT	486	0.282	0.388	0.047	0.161	0.352
SIZE	486	24.949	1.638	23.984	25.095	26.069
LEV	486	0.642	0.197	0.518	0.667	0.789
ROA	486	0.024	0.057	0.009	0.020	0.048
MB	486	1.588	1.066	1.071	1.243	1.690
ANALYST	486	2.797	1.240	2.079	3.113	3.689
COMPENSATION	486	16.173	0.896	15.549	16.151	16.906
INDDIR	486	0.379	0.058	0.333	0.364	0.400
INSIDER	486	1.639	6.849	0.000	0.002	0.048
BIG4	486	0.591	0.492	0.000	1.000	1.000
AGE	486	4.858	0.700	4.477	5.072	5.384
RD	486	12.757	9.232	0.000	17.843	20.236
CONCENTRATION	486	0.352	0.175	0.218	0.341	0.495
TENURE	486	1.061	0.832	0.000	1.099	1.792

Notes: This table reports descriptive statistics. Panel A provides a comparison between treatment firms and control firms. The observations and statistics are at the firm level for the year before the new mandate. T-statistics are presented in parentheses. *, **, *** indicate statistical significance at the 10 percent, 5 percent, and 1 percent levels, respectively. Panel B reports descriptive statistics of key variables for the main sample, including treatment firms and propensity-score matched firms. The observations and statistics are at the firm-year level.

Table 2: Expanded Audit Report and RPTs

Panel A: Main Results

	Full Sample		PSM Sample	
	Coefficient	t-stat	Coefficient	t-stat
TREAT×POST	***-0.0529****	***(-2.29)***	***-0.0803****	***(-2.44)***
SIZE	-0.1038***	(-3.30)	-0.0885**	(-1.98)
LEV	0.5463***	(4.81)	1.2094***	(3.71)
ROA	0.2193	(1.23)	0.7498	(1.43)
MB	0.0091	(1.12)	0.0374	(1.25)
ANALYST	0.0084	(1.15)	0.0208	(1.06)
COMPENSATION	-0.0115	(-0.49)	-0.0103	(-0.34)
INDDIR	-0.1777	(-1.10)	-0.2889	(-1.13)
INSIDER	-0.0009	(-0.63)	-0.0119	(-0.47)
BIG4	0.0164	(0.35)	-0.0118	(-0.18)
AGE	0.0363*	(1.67)	0.0354	(0.40)
RD	0.0029	(1.26)	-0.0022	(-0.60)
CONCENTRATION	0.0595	(0.87)	-0.0824	(-0.46)
TENURE	-0.0224**	(-2.49)	-0.0122	(-0.58)
Year & Firm FE	YES		YES	
Observations	6415		486	
Adjusted R^2	0.554		0.780	

Panel B The Time Trend of RPTs

	Coefficient	t-stat
YEAR2015_AH	***-0.0083***	***(-0.17)***
YEAR2016_AH	***-0.0898****	***(-2.13)***
YEAR2017_AH	***-0.0076***	***(-0.15)***
YEAR2018_AH	***-0.0471***	***(-0.87)***
Control Variables	YES	
Year & Firm FE	YES	
Observations	807	
Adjusted R^2	0.030	

Notes: This table reports the results on the impact of expanded audit reports on firm's engagement in RPTs. The dependent variable is RPT, measured as the value of RPTs scaled by total assets. Panel A present the main results. In model (1), we use all non-treatment firms as control firms. In model (2), we use PSM firms as control firms. Panel B examines the difference of RPTs between A+H firms and A firms in year 2014to 2018. *YEAR2015_AH ~ YEAR2018_AH* are interactions between year dummies and indicator variable for A+H firms. Year 2014 is used as the benchmark. Please see Appendix A for variable definitions. Standard errors are clustered at the firm level. T-statistics are presented in parentheses. *, **, *** indicate statistical significance at the 10 percent, 5 percent, and 1 percent levels, respectively.

Table 3: Do EARs Attract Greater Investor Scrutiny?

	Message Board Activity		Internet Search	
	Coefficient	t-stat	Coefficient	t-stat
TREAT×POST	***0.4953****	***(3.96)***	***0.1394****	***(2.07)***
RPT	0.0233	(0.18)	0.0549	(0.62)
SIZE	0.5859***	(4.41)	0.1856*	(1.90)
LEV	-0.4168	(-0.81)	-0.6896	(-1.27)
MB	0.0580	(1.46)	-0.0285	(-0.88)
ANALYST	0.0781	(0.90)	-0.0263	(-0.57)
MEDIA	0.1165	(1.36)	0.1531***	(3.06)
ADVERTISING	-0.0143	(-1.34)	-0.0025	(-0.28)
TURNOVER	6.2096	(1.00)	3.7954	(1.26)
RETURN	0.5777***	(5.03)	0.2141***	(3.13)
SPREAD	18.9138	(0.72)	5.9515	(0.42)
INSTITUTION	-3.1411***	(-2.66)	-0.6294	(-0.85)
Year & Firm FE	YES		YES	
Observations	476		476	
Adjusted R^2	0.577		0.966	

This table reports the results of the effects of expanded audit reports on investor scrutiny. In model (1), the dependent variable is the number of posts in the first and most popular stock message board in China, EastMoney (Guba.Eastmoney.com). In model (2), the dependent variable is the number of internet searches for the firm. Both proxies are in the natural logarithm form. We include the following variables that may affect investor scrutiny: firm size(*SIZE*), leverage ratio (*LEV*), market-to-book ratio (*MB*), analyst following (*ANALYST*), media coverage (*MEDIA*), advertising expenses (*ADVERTISING*), stock turnover (*TURNOVER*), abnormal stock return (*RETURN*), bid-ask spread (*SPREAD*), institutional holdings (*INSTITUTION*). We also include *RPT* as a control variable. Standard errors are clustered at the firm level. T-statistics are presented in parentheses. *, **, *** indicate statistical significance at the 10 percent, 5 percent, and 1 percent levels, respectively.

Table 4: Does Increased Investor Scrutiny Lead to RPT Reduction?

Panel A: Conditional on the Percentage of Professional Investors

	Low Professional Investors		High Professional Investors	
	Coefficient	t-stat	Coefficient	t-stat
TREAT×POST	***-0.1799****	***(-2.97)***	***0.0034***	***(0.09)***
Control variables	YES		YES	
Year & Firm FE	YES		YES	
Observations	237		249	
Adjusted R^2	0.773		0.806	
Difference: Low-High	***-0.1833***(Z-Statistic=-2.58)***			

Panel B: Conditional on Message Board Activity

	High Message Board Activity		Low Message Board Activity	
	Coefficient	t-stat	Coefficient	t-stat
TREAT×POST	***-0.1558****	***(-2.57)***	***0.0028***	***(0.09)***
Control variables	YES		YES	
Year & Firm FE	YES		YES	
Observations	245		241	
Adjusted R^2	0.769		0.779	
Difference: High-Low	***-0.1586**(Z-Statistic=-2.32)***			

Panel C: Conditional on Internet Search

	High Internet Search		Low Internet Search	
	Coefficient	t-stat	Coefficient	t-stat
TREAT×POST	***-0.1367****	***(-2.35)***	***-0.0022***	***(-0.07)***
Control variables	YES		YES	
Year & Firm FE	YES		YES	
Observations	245		241	
Adjusted R^2	0.773		0.755	
Difference: High-Low	***-0.1345**(Z-Statistic=-2.01)***			

Panel D: Conditional on the Probability of Receiving RPT-related EARs

	High Probability		Low Probability	
	Coefficient	t-stat	Coefficient	t-stat
TREAT×POST	***-0.1709****	***(-2.91)***	***-0.0243***	***(-0.83)***
Control variables	YES		YES	
Year & Firm FE	YES		YES	
Observations	236		244	
Adjusted R^2	0.774		0.820	
Difference: High-Low	***-0.1466**(Z-Statistic=-2.24)***			

Notes: This table reports the moderating effect of professional investor shareholdings on the effects of expanded audit reports. In Panel A, the PSM sample is partitioned into sub-samples based on the percentage of shares held by professional investors in the firm. We define professional investors as mutual funds, security companies, QFII (i.e., Qualified Foreign Investors), and other financial institutions. The dependent variable (*RPT*) is the value of RPTs scaled by total assets. In Panel B, the PSM sample is partitioned based on the the number of posts in the first and most popular stock message board in China, EastMoney (Guba.Eastmoney.com). In Panel C, the PSM sample is partitioned based the number of internet searches for the firm. In Panel D, the PSM sample is partitioned into sub-samples based on the ex ante likelihood that the auditor will discuss RPTs in EAR. In spirit of Fang et al. (2018) and Burke et al. (2023), we estimate the likelihood of discussing RPTs in EAR by constructing prediction model, whose determinants include: six categories of RPTs (sales and purchases of goods/service, sales and purchases of assets/equity, intercorporate lending and borrowing), firm size, financial leverage, return on assets, Big 4 auditor, an indicator for negative income, restatement disclosure and marketization index. The dependent variable (*RPT*) is the value of RPTs scaled by total assets. Please see Appendix A for variable definitions. Standard errors are clustered at the firm level. T-statistics are presented in parentheses. *, **, *** indicate statistical significance at the 10 percent, 5 percent, and 1 percent levels, respectively.

Table 5: Do Firms Respond to Investor Scrutiny?

Panel A: Conditional on Local Government Ownership (LGO)

	Non-LGO		LGO	
	Coefficient	t-stat	Coefficient	t-stat
TREAT×POST	***-0.1119****	***(-2.83)***	***0.0176***	***(0.39)***
Control Variables	YES		YES	
Year & Firm FE	YES		YES	
Observations	330		156	
Adjusted R^2	0.796		0.683	
Difference: Non-LGO-LGO	***-0.1295** (Z-Statistic=-2.17)***			

Panel B: Conditional on Corporate Importance

	Low Importance		High Importance	
	Coefficient	t-stat	Coefficient	t-stat
TREAT×POST	***-0.1608****	***(-2.91)***	***0.0131***	***(0.46)***
Control variables	YES		YES	
Year & Firm FE	YES		YES	
Observations	238		248	
Adjusted R^2	0.776		0.754	
Difference: Low-High	***-0.1739***(Z-Statistic=-2.79)***			

Notes: This table reports the moderating effect of political influences on the effects of expanded audit reports. In panel A, the PSM sample is partitioned into sub-samples based on whether the ultimate controlling shareholder is the local government or not. In panel B, the PSM sample is partitioned into sub-samples based on the importance of the firm in providing employment opportunities to the local economy, measured as the number of employees of the firm divided by the sum of the number of employees of all firms headquartered in the same province. The dependent variable (*RPT*) is the value of RPTs scaled by total assets. Please see Appendix A for variable definitions. Standard errors are clustered at the firm level. T-statistics are presented in parentheses. *, **, *** indicate statistical significance at the 10 percent, 5 percent, and 1 percent levels, respectively.