

# Audit Quality and Financial Reporting Quality: Evidence from China

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**Abstract.** The implementation of effective auditing procedures facilitates the production of superior financial reports. This study examines the impact of high-quality audits on the quality of financial reports, employing data from public sources and Chinese company databases during the period from 2000 to 2022. The implementation of effective auditing procedures facilitates the production of superior financial reports, particularly when such information is utilized in the business decision-making. The quality of audits is a significant determinant of the reliability of financial reporting. When auditors and clients have differing perspectives, it can have adverse implications for the financial stability of the company. Audit quality is particularly salient for smaller firms. The findings of this study indicate that the integration of robust internal controls and comprehensive audits can enhance the quality of financial reporting. This study elucidates the impact of audits on the broader economic landscape and underscores the vital role of auditing in ensuring the integrity of financial reporting. The insights derived from this study can inform the practices of accounting firms and regulatory bodies. However, further research is recommended to gain a more nuanced understanding.

**Keywords:** Quality of financial reporting; Audit quality; Listed companies; Exogenous policies.

## 1. Introduction

In the challenging world of corporate finance, the credibility and reliability of financial reporting have become the focus of intense scrutiny by investors, regulators and market players. A recent spate of financial misconduct cases, in particular the high-profile case involving China's Everglade World Group and PricewaterhouseCoopers, has highlighted the intrinsic link between the caliber of the audit and the veracity of financial disclosures. Everglade Group egregiously inflated its revenues and profits by hundreds of billions of dollars through the tactic of premature revenue recognition. As the designated auditor, PwC regrettably failed in its role to effectively detect and report these fraudulent activities, leading to a fundamental misinterpretation of Everglade's financial health in the eyes of investors and the broader market. In a parallel scenario, Ruixing Coffee's fabrication of transactions worth an astonishing 2.2 billion yuan went undetected by its auditor, Ernst & Young, culminating in a precipitous nosedive in the company's share price, a severe erosion of its market capitalization and a widespread crisis of confidence in the entire category of mid-cap stocks. These events highlighted the crucial fact that the quality of audit practice is inseparable from the reliability of financial reporting and the level of public confidence in business.

The interplay between the caliber of corporate audits and the integrity of financial reporting constitutes a pivotal yet intricate matter. Audit quality is intricately linked to the precision and reliability of financial disclosures, which subsequently shape investor decision-making and the market's confidence in the enterprise at large. Superior audit quality is instrumental in mitigating the disparity of information between corporate management and shareholders, thereby enhancing financial transparency and averting instances of financial malfeasance. However, audit quality is subject to a spectrum of determinants, such as the professional acumen of auditors, the meticulousness of audit procedures, and the autonomy of audit functions. A thorough investigation into this area is essential for refining auditing practices, informing regulatory frameworks, and elevating the standard of financial information presented to stakeholders (Knechel et al., 2012)(FRC, 2006).

The quality of audits is of paramount importance in ensuring the accuracy and reliability of financial reporting, which is essential for improving investment efficiency. The study by Elaoud and Jarboui (2017) emphasizes the role of external auditing in enhancing the quality of financial reporting,

which has a significant impact on reducing information asymmetry and improving investment efficiency. Agency theory posits that high-quality audits can serve as a mechanism to mitigate agency problems. The auditing process serves to reduce information asymmetry between owners and managers by increasing the reliability and transparency of financial information, thereby providing independent validation of firms' financial reports. Consequently, firms with high audit quality are able to monitor managers more effectively, reduce agency costs, and increase investment efficiency (Assad and Alshurideh, 2020). Financial reporting is an important tool for companies to communicate with external investors. The provision of high-quality financial reporting can facilitate the generation of more accurate and timely financial information, thereby reducing the information asymmetry between external investors and company management. This, in turn, can result in a reduction in external financing costs and an improvement in the efficiency of investment decisions (Biddle et al., 2009). In conclusion, investment efficiency represents the pinnacle of a firm's financial well-being and long-term prosperity. The quality of audits and financial reporting are crucial elements in attaining this objective. Collectively, they facilitate investment efficiency by reducing information asymmetry and enhancing the caliber of decision-making.

## **2. Literature Review**

### **2.1 Audit Quality**

The ownership of business entities that comprise shares and investments is often distributed among diverse stakeholders. The ongoing evolution of the business landscape has underscored a progressively heightened demand for robust auditing procedures. The divergence between shareholders and corporate management necessitates a regulatory framework within which the financial reports, crafted by management and proffered to shareholders, are rigorously examined for their accuracy and fairness. The Statement of Fundamental Auditing Concepts (ASOBAC) encapsulates the essence of auditing as a systematic endeavour, designed to objectively amass and appraise evidence pertinent to assertions regarding a myriad of economic activities or occurrences. This process is instrumental in ascertaining the congruence among these assertions. Audit engagements are executed by an independent third party or an external organization, a practice that is deemed crucial for the integrity of the corporate entity (Probohudono et al.). The efficacy of the audit process is articulated within the audit report, which in turn acts as a metric for gauging audit quality. The concept of audit quality, while critical, is shrouded in debate and remains a contentious issue within both practical and theoretical spheres. In light of this, contemporary research within the auditing discipline has gravitated towards a concentrated examination of audit quality (Knechel, Krishnan, Pevzner, Shefchik and Velury, 2012). Audit quality is perceived through a multifaceted lens by various stakeholders, each defining it based on their specific applications and needs. Financial statement users, for instance, view a high-quality audit as one that effectively precludes the presence of significant inaccuracies within financial statements. Conversely, the broader societal context and audit firms may regard a high-quality audit as one that equips the company with a robust defence against potential litigation. The UK Financial Reporting Council acknowledges the absence of a universally recognized definition of audit quality that could serve as a standardized criterion for performance assessment (2006).

### **2.2 Financial Reporting Quality**

Financial reporting quality refers to the accuracy, completeness, and reliability of financial statements as they are prepared and presented to external users. These users include investors, creditors, and other stakeholders who rely on this information to make economic decisions. The quality of financial reporting is underpinned by adherence to accounting standards, which vary across countries, reflecting their unique regulatory environments and business practices.

Empirical research, such as the study by Muhammad Umar Kibiya, Ayoib Che-Ahmad, and Noor Afza Amran in the *International Journal of Economics and Financial Issues*, has demonstrated that

audit committee characteristics, including independence and financial expertise, are positively associated with the quality of financial reporting. This research underscores the importance of audit committees in enhancing the credibility and reliability of financial information presented to stakeholders.

The quality of financial reporting is a cornerstone of corporate transparency, which is essential for stakeholders to accurately assess a company's financial health. This quality is shaped by compliance with accounting standards, the robustness of the audit process and the strength of governance mechanisms such as audit committees. A deeper understanding can be achieved through academic research. For example, the study "Audit Committee Independence, Financial Expertise, Share Ownership and Financial Reporting Quality: Further Evidence from Nigeria" highlights the positive correlation between audit committee characteristics and financial reporting quality in listed companies. In addition, the International Journal of Economics and Financial Issues explores broader economic and financial dimensions, including the impact of regulatory changes and corporate governance on reporting quality. Together, these resources provide a comprehensive view of the determinants of financial reporting quality and offer valuable insights for improving the transparency and reliability of financial information.

The utilisation of financing, investment, operating, and distribution-related indicators to assess the quality of financial reporting is of paramount importance, as they offer a comprehensive insight into the financial health and performance of an enterprise. They facilitate transparency and provide stakeholders with a comprehensive understanding of an enterprise's sources of funds, the efficiency with which they are utilised, and the distribution of earnings. Furthermore, these metrics assist in the evaluation of an enterprise's compliance with applicable accounting standards and regulatory requirements. Furthermore, they are essential for risk assessment, decision-making support, performance evaluation, market confidence, and the effectiveness of internal controls. The utilisation of these indicators facilitates the identification and prevention of financial statement irregularities or fraudulent activities, the safeguarding of stakeholder interests, and the assurance of equitable returns and access to information. Furthermore, they assist in evaluating the long-term viability of the enterprise, assessing the efficacy of resource allocation, and reflecting the quality of the surplus. Collectively, these indicators constitute a pivotal framework for evaluating an enterprise's financial transparency, compliance, risk, and performance. They serve as indispensable tools for management, investors, and other stakeholders to make informed decisions.

### **3. Research Hypotheses**

The 2019 studies conducted in Jakarta, Indonesia and Penang, Malaysia posited that investors utilise the auditor's opinion on the company's financial statements to assess the company's compliance in preparing the financial statements. This entails analysing the figures to assess the company's current situation and future prospects, with the objective of measuring the accuracy and reliability of the financial performance in terms of the investor's reaction. The study hypothesises that high financial performance and high audit quality will elicit a positive response from investors, while low financial performance and low audit quality will elicit a negative response from investors. In order to analyse the relationship between financial performance and audit quality, audit quality was measured. This study adopted the methodology used in previous studies to measure audit quality using perceived agent quality (PAQ). This includes factors such as firm audit size, audit fees, reputation, specialisation and audit adjustments. The findings of the study indicate that audit quality has a positive effect on the accuracy and reliability of financial performance information. This is particularly evident when investors react negatively to high financial performance but low audit quality. This highlights the significance of audit quality in the information provided to investors. This leads to the formulation of a hypothesis, namely:

H1: There is a positive effect of audit quality on corporate financial performance.

Auditors with specialised knowledge in certain industries or financial areas may be better equipped to identify and address potential problems in a company's financial reporting. This could lead to more accurate and reliable financial statements, which in turn could enhance the credibility and financial performance of the company. The study found that auditors' industry specialisation improves the quality of financial reporting. This relationship is strengthened when the client's business strategy deviates from the conventional industry strategy. This suggests that auditors with expertise in a particular industry or financial area may be better able to identify and address potential problems in a company's financial reporting, thereby improving the accuracy and reliability of financial reporting and enhancing the company's credibility and financial performance. (Soroushyar, 2023). On this basis, the hypothesis is elicited:

H2: Auditor's specialization has a significant positive effect on corporate financial performance.

The impact of external pressures on auditors may influence the financial performance of an enterprise. However, the extent to which this occurs requires a detailed analysis of the source and nature of the external pressures in question. External pressures may include the requirements of regulators, market and media scrutiny, legal and regulatory constraints, and the expectations of clients and the public. Such pressures may compel auditors to subject corporate financial reports to more rigorous scrutiny and to enhance the quality of their audits, thereby contributing to the veracity and transparency of corporate financial information (Zhang, Wang and Yan, 2020). However, if the external pressures are excessive, resulting in an overwhelming workload and pressure on auditors, they may also affect their independence and objectivity. This may even cause auditors to focus unduly on certain risk areas while neglecting other equally important aspects.

H3a: Auditor's external pressure has a significant negative effect on corporate financial performance.

H3b: Auditor's external pressure has a significant positive effect on corporate financial performance.

Furthermore, the selection of an auditor is associated with enterprise value. The quality of audit services provided by auditors with different characteristics (size and industry expertise) varies. Consequently, the choice of auditors with different characteristics will have different impacts on firm value.

H4: Auditor's mismatch has a significant negative effect on corporate financial performance.

Small enterprises, limited by resources, are highly sensitive to the link between audit quality and financial reporting. High-quality audits are vital for reducing agency costs and enhancing transparency, especially in these firms where management and ownership often overlap. Signaling theory highlights how superior audits boost the appeal of financial reports to investors. With limited internal controls, small firms depend on audits to manage risks and ensure compliance. Quality audits also help demonstrate the reliability of financial reports, aiding capital acquisition and market competitiveness. They are key to long-term sustainability and social responsibility. In essence, for small businesses, audit quality is crucial for financial reporting accuracy, market standing, and enduring success.

H5: Compared with larger-sized firms, small-sized firms' audit quality has a larger effect on corporate financial performance.

In the relationship between audit quality and corporate financial performance, sufficient investment plays a moderating role. Sufficient investment provides the necessary resources for a company to operate effectively and efficiently. This can include investments in better infrastructure, technology, and human capital, which can enhance the company's operational capabilities and, in turn, improve its financial performance. Additionally, high audit quality can boost investor and market confidence in a company's financial statements. When sufficient investment aligns with audit quality, it can reassure stakeholders that the company is financially stable and has a clear strategy for growth. This can potentially lead to better access to capital and a lower cost of capital (Yang, 2015). However, the extent to which investment moderates the relationship between audit quality and financial

performance varies depending on the industry, company size, and specific circumstances. Empirical research and analysis are required to determine the nature and strength of this moderating effect.

H6: Sufficient investment plays a moderating role in the relationship between audit quality and corporate financial performance.

Internal control is an essential component of an organisation's governance structure, with the objective of ensuring the accuracy and reliability of financial reporting, compliance with laws and regulations, and operational efficiency. Internal controls serve to moderate the relationship between audit quality and corporate financial performance. Strong internal controls can enhance the efficiency and effectiveness of the audit process (Chalmers, Hay and Khelif, 2019). Auditors can rely on internal controls to reduce the risk of material misstatements in the financial statements, thereby improving audit quality.

H7: Internal control plays a moderating role in the relationship between audit quality and corporate financial performance.

## 4. Methodology

### 4.1 Data

The secondary data employed in this study originate from the Audit Research Database of Chinese Listed Companies, which has been subjected to review by four academic institutions, including the Central University of Finance and Economics and the Southwestern University of Finance and Economics. Additionally, the study makes use of public disclosure reports from the China Securities Regulatory Commission (CSRC), the China Institute of Certified Public Accountants (CICPA), the 2012 CSRC Industry Classification Standards (ICS), authoritative C-journal literature, Audit Opinion, and other sources. To ensure the integrity of the data, samples with missing underlying data have been excluded. The data span the period 2000-2022. The sample was collected at the firm level and comprises 129 listed Chinese firms.

### 4.2 Variable

The activities of an enterprise can be classified into four principal categories: financing, investment, operation and distribution. In this paper, the quality of financial reporting is gauged by means of indicators that reflect the operational capabilities of enterprises in financial data. The current ratio represents a fundamental financial indicator, offering insight into the company's capacity to fulfill its obligations in the near future. Consequently, it is an immediate indication of a company's capacity to procure capital. It is easier for such enterprises to obtain bank loans and bond financing, and the cost of financing is relatively low. Operating income is revenue earned from engaging in principal or other businesses and can be a direct reflection of operations. The ratio of net cash flow from operating activities to current liabilities is a key indicator of a company's operating efficiency. It directly indicates the company's ability to generate cash flow through daily operations. A high ratio indicates that the company is adept at managing its current assets and liabilities and has the capacity to meet its short-term financial obligations. The share issue premium is a direct indicator of a company's ability to attract investment, i.e., an indicator of its ability to raise funds. The long-term capital debt ratio indicator is mainly used to reflect the proportion of long-term interest-bearing liabilities to the overall long-term working capital of the enterprise, reflecting the pressure on the enterprise's operation and measuring the enterprise's operating ability with the help of the capital structure. The exception to this is investment efficiency, which is calculated separately.

The primary variable under investigation in this study is audit quality, which is defined as the quality and effectiveness of audit work and audit results. The audit quality (AQ) measure proposed in this paper represents a novel quantitative instrument devised to evaluate the quality of an audit by quantifying the extent of discrepancy between the actual audit opinion and the anticipated probability of issuing an unqualified opinion. The audit opinion represents the fundamental element of the audit report, encapsulating the auditor's assessment of the veracity and fairness of the financial statements

presented by a company. An unqualified opinion typically signifies that the auditor deems the financial statements to be an accurate representation of the firm's financial position. The article employs a Stata learning model to forecast the probability of attaining an unqualified opinion on financial statements in the absence of audit evidence. This is based on a number of factors, including the financial characteristics of the firm in question, industry standards, and the results of previous audits. The utilisation of negative absolute values signifies that the study is focused on the discrepancy between the actual audit opinion and the predicted probability. The greater the degree of deviation, the greater the discrepancy between the audit results and the anticipated outcome.

The calculated AQ metrics measure audit quality from the perspective of the company, the industry, and the data results. In practice, the auditor, as the producer of the audit report, changes are also an influence on audit quality. In this paper, based on practice, auditor expertise, auditor pressure and auditor mismatch are selected as indicators that have an impact on audit quality from the auditor's perspective. In this paper, the indicator MSA is calculated as the value of auditor expertise. A more conservative indicator of industry market mix is employed to estimate industry expertise. To circumvent a negative operating income that cannot be taken as a square root, the total assets of the audit client are utilised in lieu of the audit fee to obtain the MSA, a measure of the auditor's industry expertise.

The auditor's mismatch value is measured by MISMACH, a calculated indicator of the expected versus actual selection of an accounting firm. Shu (2000) argues that a company's audit needs now and in the future period depend mainly on its current operating conditions and financial activities. The model is estimated using data from the full sample of firm-years. The estimated coefficients of the model are then used with the values of the variables for each firm-year to obtain a fitted value for the dependent variable. This is the estimated probability of selecting a Big4 firm for that firm, which is denoted as  $Pr_{Big4}$ . The optimal critical probability is selected in order to minimise the sum of classification errors. A client is considered a potential Big4 firm client if the estimated probability of the client selecting a Big4 firm is above the optimal critical value, or a potential Non-Big4 firm client if the estimated probability of the client selecting a Big4 firm is equal to or below the optimal critical value. The client-auditor mismatch variable is derived by comparing the expected choice of each client with their actual choice.

This paper tests for heterogeneity in financial reporting quality by firm size, above the median of the indicator set for large firms and vice versa for small firms. We employ a two-pronged approach to ascertain the size of a firm. Firstly, the total assets held by the firm are considered, and secondly, the operating income is taken into account. The size of an enterprise can be gauged by a number of indicators, including the number of employees, operating income and total assets. This paper selects the ratio of total assets to operating income as the primary indicator of enterprise size, as opposed to a singular indicator such as the number of employees, total income, or total assets. This approach is adopted because the ratio provides a comprehensive overview of the size and scope of the enterprise. The ratio provides insight not only into the size of the enterprise, but also into the efficiency of asset utilisation and operational efficiency, which can be measured by the asset turnover ratio. Furthermore, the ratio allows for a fair comparison of size across industries. Furthermore, the ratio evaluates managerial competence, as effective asset management enhances a company's operational efficiency and profitability. In conclusion, the ratio can be used to assess the adaptability and resilience of a firm in the context of economic cycles, thus providing a comprehensive and multi-dimensional indicator of the overall size of a firm.

### 4.3 Model

Hence, the main basic empirical equation is a panel effect model.

$$Reporting_{it} = a + AQ_{i,t} + Control_{i,t} + Year_t + V_i + \mu_{i,t} \quad (1)$$

$$Reporting_{it} = a + b \times (Mechanism \times AQ_{i,t}) + AQ_{i,t} + Control_{i,t} + Year_t + V_i + \mu_{i,t} \quad (2)$$

In this model, the variables "i" and "t" represent the firm and time, respectively. "reporting" represents financial reporting quality, "AQ" represents audit quality under panel data effect results,

$b \times (Mechanism \times AQ_{i,t})$  represents the mechanism results under fixed effects, "Control" represents the control variables, "Year" represents the time fixed effect, " $V_i$ " represents the individual effect, and " $\mu_{i,t}$ " represents the residual.

## 5. Research Results

### 5.1 Main Model

Firstly, the calculated audit quality indicator (AQ) and the four indicators of financial reporting quality are incorporated into a panel data effects model and a fixed panel data effects model, respectively. Table 1 illustrates the findings of both models, which are statistically significant at the 1% level with the exception of the investment indicators. An increase of one unit in AQ is associated with a 1.252 to 1.154 absolute unit increase in CR, a 0.014 to 0.018 absolute unit increase in investment efficiency, and a 0.155 to 0.2 absolute unit increase in operating indicators. These findings support the initial hypothesis, and there is a positive effect of audit quality on corporate financial performance.

Table 1 AQ & FRQ's results

Dimension	□ financing		investors		operation		allocate	
	CR		Inveffi		Net cash flows from operating activities/current liabilities		Equity issue premium	
DV	Random Effect	Fixed Effect	Random Effect	Fixed Effect	Random Effect	Fixed Effect	Random Effect	Fixed Effect
AQ	1.154** *	1.252** *	0.014** *	0.018** *	0.200** *	0.155** *	-0.000	- 0.000
	(12.227)	(13.424)	(7.876)	(9.505)	(12.116)	(9.202)	(-0.000)	(- 0.000)
Control	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Time Effect	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Individual Effect	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
N	49774	49774	35697	35697	49773	49773	49769	49769

Note: t statistics in parentheses

\*  $p < 0.1$ , \*\*  $p < 0.05$ , \*\*\*  $p < 0.01$

The implementation of rigorous auditing procedures can effectively mitigate the information asymmetry between management and external investors, ensure the provision of accurate and reliable financial information to market participants, and foster enhanced trust in the enterprise. This, in turn, can lead to a reduction in the enterprise's cost of capital and an increase in market value (Zhang Wenjie, Li Yutong, 2024). Secondly, as a crucial component of an enterprise's internal control and governance apparatus, auditing facilitates the identification and rectification of managerial deficiencies, enhances operational efficacy, and curtails waste and fraud. Furthermore, the implementation of rigorous auditing practices enables organisations to adhere to the established legal, regulatory and accounting standards, thereby mitigating the potential for financial penalties or reputational harm resulting from non-compliance. Furthermore, the assessment and management of business risks during the audit process serve to reduce uncertainty and improve the financial stability of the business.

Audit reports represent a significant means through which enterprises may signal their financial health to the market. This signaling can attract a greater number of investors and partners, thereby enhancing their financing ability and market competitiveness. This serves to confirm the signaling theory. Ultimately, audit quality may also function as an incentive mechanism for management to exert greater effort in order to enhance the financial performance of the enterprise. Conversely, superior audit quality can oversee managerial conduct, guaranteeing that their actions align with the best interests of shareholders, curtail agency costs, and enhance the financial performance of the enterprise. In conclusion, audit quality exerts a beneficial influence on an enterprise's financial performance through a range of mechanisms, including the reduction of information asymmetry, the enhancement of market confidence, the improvement of corporate governance, the reduction of agency costs, the facilitation of compliance, the management of risk, the signaling of information, and the provision of incentives. These factors collectively contribute to an improvement in the quality of financial reporting.

Following the validation of the relevance of the audit quality indicator (AQ) calculated from industry and outcome data to the quality of financial reporting, this paper establishes three branches of audit quality indicators from the auditor's perspective. The initial category is that of auditor expertise, with the outcomes presented in Table 2 being statistically significant at the 1% and 5% levels. An increase of one unit in the MSA results in a change of 4.802 units in the equity ratio and a change of 0.589 units in the operational capacity indicator, both in the same direction. This provides evidence to support the validity of hypothesis two, which is auditor's specialization has a significant positive effect on corporate financial performance.

Table 2 MSA&FRQ's results

Dimension DV	□ financing equity ratio Random Effect	operation Net cash flows from operating activities/current liabilities Random Effect
MSA	4.802*** (3.709)	0.589** (3.27)
Control	Yes	Yes
Time Effect	Yes	Yes
Individual Effect	Yes	Yes
N	55959	55036

Note: t statistics in parentheses

\* p < 0.05, \*\* p < 0.01, \*\*\* p < 0.001

Subsequently, the influence of auditor pressure is investigated. As illustrated in Table 3, the majority of the outcomes exhibit statistical significance at the 1% level. For each unit increase in Apf, the absolute value of the increase in the current ratio is in the range of 0.019 to 0.049, while the increase in operating income is in the range of RMB 181.549 million to RMB 217.133 million. This evidence substantiates hypothesis 3b and refutes hypothesis 3a, thereby confirming that Auditor's external pressure has a significant positive effect on corporate financial performance.

Table 3 Apf&FRQ's results

Dimension DV	□ financing equity ratio Random Effect	Fixed Effect	operation Net cash flows from operating activities/current liabilities Random Effect	Fixed Effect
Apf	0.019* (1.686)	0.049*** (4.261)	217.133*** (18.416)	181.549*** (15.304)
Control	Yes	Yes	Control	Yes
Time Effect	Yes	Yes	Time Effect	Yes

Individual Effect	Yes	Yes	Individual Effect	Yes
N	59708	59708	59651	59651

t statistics in parentheses

\* p < 0.1, \*\* p < 0.05, \*\*\* p < 0.01

The following section will examine the impact of auditor mismatch. The results presented in Table 4 are statistically significant at the 5% and 1% levels. The results demonstrate that when auditor mismatch occurs, namely when it increases by one unit, the current ratio decreases by 0.224 to 0.244 units in absolute value and the long-term capital gearing increases by 0.042 units. This indicates a decrease in financial performance, which corroborates the veracity of Hypothesis 4, as described by H4: Auditor’s mismatch has a significant negative effect on corporate financial performance).

Table 4 MISMATCH&FRQ’s results

Dimension DV	□ financing CR		operation long-term capital debt ratio
	Random Effect	Fixed Effect	Fixed Effect
MISMATCH	-0.244**	-0.224**	0.042***
	(-2.398)	(-1.975)	(7.441)
Control	Yes	Yes	Yes
Time Effect	Yes	Yes	Yes
Individual Effect	Yes	Yes	Yes
N	43069	43069	(75.562)

t statistics in parentheses

\* p < 0.1, \*\* p < 0.05, \*\*\* p < 0.01

### 5.2 Heterogeneity Test

Once the analysis from the auditor's perspective has been completed, the next step is to analyse the test of heterogeneity in terms of firm size. Table 5 demonstrates that the results for small-sized firms have a significance level at the 1% level, and that when AQ is increased by one unit, the CR of the financial indicator for small-sized firms increases by 1. The results indicate that, in comparison to large-sized firms, small-sized firms experience a more pronounced impact of audit quality on corporate financial performance, with an absolute increase of 275 units, as opposed to 0.222 units for large-sized firms, which is insignificant. This supports the findings of Hypothesis 5, which suggests that compared with larger-sized firms, small-sized firms’ audit quality has a larger effect on corporate financial performance.

Table 5 Heterogeneity test results for firm size

Dimension DV	L	S
	CR Random Effect	CR Random Effect
AQ	0.222	1.275***
	(0.104)	(13.635)
Control	Yes	Yes
Time Effect	Yes	Yes
Individual Effect	Yes	Yes
N	117	49657

t statistics in parentheses

\* p < 0.1, \*\* p < 0.05, \*\*\* p < 0.01

### 5.3 Mechanism Test

After completing the analysis of the test of heterogeneity in firm size the investigation of moderating factors is carried out. Table 6 shows that investment (audit fees) moderates the results at a significance level of 10%, when INVESTMENT increases by 1 unit, the increase in corporate financial indicators is 0.00205 and 0.0000409 units. This supports the conclusion of hypothesis 6 that Sufficient investment plays a moderating role in the relationship between audit quality and corporate financial performance. Table 7 shows that the internal control moderating role results in a significance level of 1%, when Control is increased by 1 unit, the corporate financial indicators are increased by 0.163, 0.002 and 0.028 absolute units respectively. This supports the conclusion of hypothesis 7 that Internal control plays a moderating role in the relationship between audit quality and corporate financial performance.

Table 8 Intermediate impact factor results:investment

Dimension DV	□ financing CR Random Effect	investors Inveffi Fixed Effect
investment	0.00205* (2.04)	0.0000409* (2.37)
Control	Yes	Yes
Time Effect	Yes	Yes
Individual Effect	Yes	Yes
N	47701	34592

investment=Total audit costs\* AQ

t statistics in parentheses

\* p < 0.1, \*\* p < 0.05, \*\*\* p < 0.01

Table 9 Intermediate impact factor results:Internal control

Dimension DV	□ financing CR Random Effect	investors Inveffi Random Effect	operation Net cash flows from operating activities/current liabilities Random Effect
Control	0.163*** (11.024)	0.002*** (6.936)	0.028*** (9.790)
Control	Yes	Yes	Yes
Time Effect	Yes	Yes	Yes
Individual Effect	Yes	Yes	Yes
N	45570	35687	45569

Control=Internal control indices are expressed in natural logarithms\* AQ

t statistics in parentheses.\* p < 0.1, \*\* p < 0.05, \*\*\* p < 0.01

## 6. Conclusion and Discussion

This paper presents novel evidence regarding the influence of audit quality on financial reporting quality. The majority of studies concur that the impact of audit quality on the quality of financial reporting is markedly positive. It is posited that financial policies exert a significant influence on firm performance, affecting free cash flow (FCF) and agency costs. Moreover, audit quality is identified as a pivotal moderating factor in this process (Kamran et al., 2023). However, some studies have indicated that audit quality may not have a significant impact on financial performance. For instance, Elewa and El-Haddad (2019) found that auditor experience, as measured by affiliation with a Big 4 accounting firm, and auditor independence, as measured by auditor rotation, did not have a notable effect on a firm's return on assets (ROA) and return on equity (ROE). The effect of audit quality on

the quality of financial reporting represents a significant research topic within the field of accounting and finance. The basic empirical equation employed in this study is a panel effect model, which examines the influence of audit quality on financial reporting quality from the perspective of the auditor. This analysis is based on the AQIs proposed by the PCAOB, as outlined below.

The practical significance of Hypothesis 1 is to establish a link between audit quality and the response of financial performance of listed firms, specifically the quality of financial reporting (FP). This provides a new perspective for understanding the economic consequences of audit quality. The findings of the study indicate that there is a positive correlation between audit quality and financial performance. Furthermore, competitive firms are more likely to achieve optimal profits and are positively associated with financial performance, whereas non-competitive firms exhibit a negative association with financial performance. Furthermore, HPMC has been identified as a significant factor in enhancing firm profits (Sattar, Javeed and Latief, 2020). As evidenced by the Audit Quality Report Overview 2021, leading professional audit firms such as KPMG Huazhen have implemented a range of measures to enhance audit quality. These include investments in new technologies, enhancements to quality control systems, and the provision of continuous professional training. These measures are designed to ensure that audits are conducted to the highest standards, thereby improving the overall quality of financial reporting.

The practical implications of hypotheses 2, 3 and 4 are to consider financial performance from the perspective of auditor selection. Some findings indicate that the experience of the auditor (as measured by affiliation with a Big 4 accounting firm) and the independence of the auditor (as measured by the implementation of an auditor rotation system) do not exert a significant influence on a firm's return on assets (ROA) and return on equity (ROE) (Elewa and El-Haddad, 2019). Our study is more human-centric in terms of auditor expertise, pressure, and alignment. The results demonstrate that auditor expertise and pressure contribute to the quality of financial reporting, whereas auditor mismatch has a detrimental impact on firms' financial performance. The extant literature demonstrates that auditor industry expertise enhances audit quality, a relationship that has been corroborated by empirical studies (Yan and Xie, 2016). Moreover, other studies have investigated the influence of auditor expertise on audit quality, with findings indicating that auditor industry expertise can enhance audit quality, particularly in the context of audits of financially fraudulent firms. Conversely, appropriate pressure can motivate auditors to adopt a more focused and meticulous approach. However, auditors may experience elevated levels of stress due to constraints such as time limitations and human resource shortages, which could influence their behaviour and the quality of their audits (Yan and Xie, 2016). A discrepancy between the auditor's expertise and the client's requirements may result in a reduction in the quality of audit services, which could subsequently have a detrimental impact on the firm's financial performance. For instance, it has been demonstrated that the implementation of effective internal controls can markedly enhance a firm's capacity for innovation and mitigate financial discrepancies (Li and Zhao, 2022).

Secondly, an analysis of variance (ANOVA) was conducted to investigate the impact of audit quality on the quality of financial reporting, with the additional factor of firm size. The results for small firms have a significance level of 1 percent, which lends support to the findings of hypothesis 5. It is generally accepted that the impact of audit quality on firms' financial performance is more significant for small firms than for large firms. This is mainly because small firms tend to be relatively limited in terms of resources, internal controls and risk management. It can be concluded that external audits play a more critical role in providing independent validation and enhancing the credibility of financial reporting. The extant literature indicates that high-quality external audits in small firms are associated with improved internal controls, which in turn is associated with superior financial performance (Velte, 2022). Furthermore, small firms with restricted resources may be more inclined to rely on external audits to identify and prevent potential financial issues, thereby reducing losses and risks. In conclusion, high-quality external audits in small firms have a significant positive impact on firms' internal controls and financial performance, a conclusion that has been reached through extensive study and confirmed in the literature on foreign firms.

Thirdly, the study employs a test of the mechanisms through which investment and internal control arise. The relationship between audit quality and firms' financial performance was moderated by both audit fees and internal control, with hypotheses 6 and 7 being supported by the data. When firms' internal controls are weak, auditors may charge higher fees to compensate for the increased audit risk and workload. In this instance, the rise in audit fees may prompt firms to reinforce their internal controls, thus enhancing financial performance. For example, one study examined the effect of performance shares on audit fees and found that an increase in performance shares leads to an increase in audit risk, which in turn leads to an increase in audit fees (Wang, 2020). The role of audit fees as a moderating factor in the relationship between audit quality and firm financial performance is of significant relevance in understanding the pricing mechanism of audit services and improving both audit quality and firm financial performance. Both external audit quality and corporate financial performance have a significant positive impact on the internal control of firms, and they have a complementary relationship in improving the internal control of firms (Fu, 2023). It can assist firms in developing a more comprehensive understanding of their internal control systems and enhance the precision and dependability of their financial reporting. This, in turn, can attract additional investment and bolster the firm's market competitiveness and financial stability. The enhancement of internal audit quality can facilitate the optimisation of the corporate governance structure, enhance the effectiveness of corporate governance, prevent financial risks, ensure the preservation and appreciation of corporate assets, and thus increase the market value and performance of the company (Li, 2021).

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