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Litigation Risk and Key Audit Matters Disclosure: The Moderating Role of Board Characteristics

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Abstract
This study investigates the relationship between litigation risk and the disclosure of Key Audit Matters (KAMs) in China, using data from 14,679 non-financial A-share firms from 2017 to 2023. The results indicate that higher litigation risk leads to increased KAM disclosure. Further analysis reveals that certain board characteristics moderate this relationship, with varying effects across different characteristics: board size strengthens it, the proportion of independent directors weakens it, and CEO duality has no significant effect. These findings confirm that KAMs effectively communicate litigation-related risks and underscore the influence of corporate governance on auditors' reporting behavior.

Keywords: Litigation Risk; Key Audit Matters; Board Characteristics

1.0 Introduction

In recent years, with the continuous improvement of the legal system and the increasingly complex business environment, litigation has become an important means for listed companies to resolve disputes (Zheng & Lei, 2025). However, for enterprises, this approach involves high costs and lengthy legal procedures, making litigation risk one of the major uncertainties faced by listed firms (Zheng & Lei, 2025). Existing studies have shown that the growing number of lawsuits exerts a negative impact on firms' operational performance and poses a threat to the sustainable development of listed companies (Zhang et al., 2025).

To protect investors' interests, the Stock Listing Rules of both the Shanghai Stock Exchange and the Shenzhen Stock Exchange—which were implemented in 1998 and revised in 2025—stipulate that listed companies must promptly disclose any litigation or arbitration matters when the amount involved exceeds CNY 10 million and represents more than 10% of the company's most recently audited net assets. Furthermore, the Shenzhen Stock Exchange Stock Listing Rules require listed companies to promptly disclose major developments in litigation and arbitration matters, including first and second-instance rulings, arbitration awards, enforcement of judgments or awards, and the expected impact on the company. However, some listed firms have attempted to conceal litigation risks to avoid negative effects on their sustainable operations and stock prices. For instance, according to Administrative Penalty Decision [2024] No. 122 issued by the China Securities Regulatory Commission (CSRC), Zixin Pharmaceutical failed to disclose litigation involving the Ruixiang Branch of Jilin Bank in its 2020 and 2021 annual reports. The amount in dispute was RMB 581 million, accounting for 15.53% and 21.07% of the company's audited net assets in 2020 (RMB 3.741 billion) and 2021 (RMB 2.757 billion), respectively.

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Recent research on litigation risk has primarily focused on its impact on firm value, disclosure practices, audit fees, and earnings management (Donelson et al., 2024). Auditing, as a governance mechanism, aims to address agency problems and reduce information asymmetry. In 2016, the Chinese Ministry of Finance issued China Certified Public Accountants Auditing Standard No. 1504—Communication of Key Audit Matters in the Audit Report (CSA 1504), which requires auditors to disclose key client risks and how they are addressed. This standard provides auditors with an additional tool to communicate client risks to information users (Camacho-Miñano et al., 2024), and serves as a new channel through which auditors can alert investors to a company's litigation risks.

Under CSA 1504, auditors are required to communicate with those charged with governance to identify company-specific risks. The board of directors is a central component of corporate governance (Tricker, 2015). Prior research indicates that characteristics of corporate governance may be associated with auditors' risk assessments and reporting behavior (e.g., Fakhfakh & Jarboui, 2022; Feng et al., 2020), including the role of audit committee characteristics or the relationship between board characteristics and KAM disclosure (e.g., Noureldeen et al., 2024; Zhang & Shailer, 2022). However, limited research has explored how board characteristics moderate the relationship between litigation risk and KAM disclosure.

Therefore, this study uses a sample of 14,679 non-financial A-share listed firms from the Shanghai and Shenzhen stock exchanges between 2017 and 2023 to examine how litigation risk affects the disclosure of KAMs and whether board characteristics moderate this relationship. This research contributes to the limited literature on the ex-ante determinants of KAM disclosure in the context of the rapid rise of corporate litigation in China and also extends the literature on the effectiveness of corporate boards in the governance of listed Chinese firms.

2.0 The Literature Review and Research Hypotheses

2.1 Litigation Risk and Key Audit Matters

During routine business operations, companies may face legal disputes and litigation due to intentional misconduct, negligence, or attempts to circumvent regulatory requirements, leading to violations of laws, regulations, or contractual obligations. When firms are named as defendants in such cases, they often incur adverse legal liabilities and substantial financial consequences (He & Shi, 2023). Even when acting as plaintiffs, the unpredictable nature of litigation often results in unsatisfactory outcomes for companies (Liu et al., 2020). Therefore, the uncertainty and high risk inherent in litigation can adversely affect a firm's market valuation, stock price reactions, policy implementation, and overall performance.

Moreover, Beck and Bhagat (1998) find that firms involved in litigation tend to perform worse and exhibit higher systematic risk compared to their non-litigated counterparts. These firms are also more likely to disseminate favorable news during periods of misleading litigation disclosures. Given this, companies facing litigation risk are more susceptible to public and media scrutiny (Liu et al., 2018), and their management may resort to earnings manipulation or even fraudulent financial reporting to preserve their corporate image. In addition, under Chinese accounting standards, the accounting treatment of pending litigation involves judgment-based estimates, which can be influenced by the competence of accounting personnel and the opportunism of management. This creates opportunities for earnings manipulation under conditions of information asymmetry.

Furthermore, Wu et al. (2020) suggest that litigation risk is often a consequence of underlying corporate governance deficiencies, and that firms with weaker governance structures are more prone to significant risks and material misstatements. Field et al. (2005) argue that high-quality auditors may be reluctant to engage with litigious clients, as they seek to avoid reputational or legal liability (Wu et al., 2020). Sun and Liu (2011) demonstrate that when clients are exposed to higher litigation risk, large audit firms tend to exert greater audit effort, applying more professional expertise and judgment to the audit process and oversight of financial reporting systems. Drawing upon these findings, this study proposes the following hypothesis:

Hypothesis 1: Litigation risk is positively associated with the disclosure of Key Audit Matters.

2.2 Board Characteristics

Prior research suggests that the board of directors influences audit services through both formal and informal channels (Desender et al., 2009). Formally, boards are involved in auditor selection and approval of audit scope. Informally, auditors may enhance audit quality to align with board expectations and preserve client relationships. Board characteristics, such as size, independence, and CEO duality, affect firm risk and reporting transparency, which in turn shape audit procedures and KAM disclosures (Singh & Sultana, 2011).

Board size significantly affects firm risk, audit demand, and audit quality. Larger boards provide diverse expertise, improving oversight and reducing financial reporting risk (Anderson et al., 2004). They are associated with lower performance volatility and bankruptcy risk, and demand more extensive audits and higher audit quality (Jizi & Nehme, 2018). However, some studies argue that coordination and communication issues in large boards may weaken audit effectiveness (Khudhair et al., 2019). Thus, its overall effect remains inconclusive.

Independent directors enhance monitoring due to reputational concerns, reducing agency costs and improving decision-making. They strengthen audit committees, promote accounting conservatism, and support higher audit quality (Ahmed & Duellman, 2007). Such boards prefer high-quality auditors and thorough audit tests (Desender et al., 2009). However, some studies find limited influence on auditor choice or audit fees (Krishnan & Visvanathan, 2009), suggesting mixed evidence on their effectiveness.

CEO duality, where one person serves as both CEO and Chairman, is linked to weaker governance, higher firm and audit risk, reduced transparency, and increased earnings management (Jizi & Nehme, 2018). However, some studies argue CEO duality aligns management and shareholder interests or demands better audit quality (Desender et al., 2009), highlighting mixed empirical findings. On this basis, the hypotheses are formulated as follows:

H2: The relationship between the firm's litigation risk and the KAMs disclosure is significantly moderated by board characteristics.

3.0 Research Design

3.1 Sample Selection and Data Sources

The study focuses on Chinese A-share companies listed on the Shanghai and Shenzhen exchanges between 2017 and 2021. After CSA 1504 took effect on January 1, 2018, these firms were required to include KAMs section in the audit reports for their 2017 year-end financial statements issued in 2018. We excluded financial institutions, ST/*ST or delisted entities, and observations with incomplete data. Continuous variables were winsorized at the 1st and 99th percentiles each year. The resulting sample comprises 14,679 firm-year observations.

3.2 Variable Definitions

Prior research has measured litigation risk using four main approaches (Qin et al., 2021). The first uses a dummy variable equal to 1 if a firm discloses any lawsuits in a given fiscal year and 0 otherwise (Wu et al., 2020). The second counts the number of lawsuits the firm faces each year (Qin et al., 2021). Both approaches treat all suits equally and overlook variations in severity or financial impact. The third sums the annual litigation amount—comprising underlying asset values, interest, and penalties—and standardizes it by total assets (X. Liu et al., 2020), net assets, or operating revenue (Zhang et al., 2025), effectively capturing potential financial losses. The fourth takes the natural logarithm of the monetary claim against the defendant divided by its total assets (Wu et al., 2020; Zheng & Lei, 2025), which can exaggerate risk for firms with smaller asset bases. In line with the CSMAR Database, this study uses the monetary amount involved in major litigation and arbitration cases each year as a proxy for corporate litigation risk. This amount is standardized by the firm's net assets in the same year, providing a measure that reflects the potential financial losses a company may face due to litigation.

Following the approach of Pinto and Morais (2019), the disclosure of KAMs is measured by the total number of key matters reported in the KAMs section of the audit report. Consistent with Noureldeen et al. (2024), the board characteristics are measured by board size, board independence, and CEO duality. Drawing on recent literature (e.g., Pinto & Morais, 2019; Srisuwan et al., 2024), this study includes several control variables in the KAMs model, such as firm size, return on assets, loss status, ownership concentration, accounts receivable, and whether the auditor is from a Big Four firm. Industry and year fixed effects are also controlled for. Detailed definitions of all variables are provided in Table 1.

Table 1. Variable Definition

Variable Name	Variable Symbol	Variable Definition
Key Audit Matters	KAMs	The total number of matters mentioned in the KAMs section of the annual audit report of listed companies
Litigation Risk	LIT	The total amount of litigation involving the company each year, comprising the value of underlying assets, interest, and penalties divided by the company's net assets.
Board Size	BOD_SIZE	The total number of directors on the board of directors at the end of the year.
Board Independence	BOD_IND	The proportion of independent directors on the board of directors at the end of the year.
Duality	DUALITY	A dummy variable that equals 1 if the CEO is also the chairman of the board of directors and 0 otherwise.
Firm Size	SIZE	The natural logarithm of the book value of the firm's total assets.
Loss	LOSS	A dummy variable equals to 1 if the firm has net income of less than zero in a current year and 0 otherwise.
Ownership Concentration	OWNCONC	The proportion of a firm's total number of outstanding shares held directly and indirectly by the largest shareholder of the listed company at year-end
Accounting Receivable	OREC	The amount of accounts receivable divided by total assets at the end of current year.
BIG 4	BIG 4	A dummy variable set to 1 if the firm is audited by a Big 4 audit firm (PricewaterhouseCoopers, Deloitte, Ernst & Young, or KPMG) and 0 otherwise.

3.3 Research Model

Consistent with prior research on KAM disclosures (e.g., Pinto & Morais, 2019; Srisuwan et al., 2024), this study estimates two fixed-effects regression models to test Hypotheses 1 and 2, respectively. Specifically, Model (1) examines the relationship between litigation risk and the total number of KAMs disclosed in the expanded auditor's report, whereas Model (2) investigates this relationship while incorporating the moderating effects of board characteristics.

$$KAMs_{i,t} = \alpha_0 + \beta_1 LIT_{i,t} + \beta_2 SIZE_{i,t} + \beta_3 Control_{i,t} + \sum Industry_{i,t} + \sum Year_t + \varepsilon_{i,t} \tag{1}$$

$$\begin{aligned} NUM\_KAMs_{i,t} = \alpha_0 &+ \beta_1 LIT_{i,t} + \beta_2 BOD\_SIZE_{i,t} + \beta_3 BOD\_IND_{i,t} + \beta_4 DUALITY_{i,t} \\ &+ \beta_5 LIA_{i,t} \times BOD\_SIZE_{i,t} + \beta_6 LIA_{i,t} \times BOD\_IND_{i,t} + \beta_7 LIA_{i,t} \times DUALITY_{i,t} \\ &+ \beta_8 Control_{i,t} + \sum Industry_{i,t} + \sum Year_t + \varepsilon_{i,t} \end{aligned} \tag{2}$$

Where $KAMs_{i,t}$ denotes the total number of matters mentioned in the annual audit report, $LIT_{i,t}$ denotes the total amount of litigation involving the company each year divided by the company's net assets. $BOD\_SIZE_{i,t}$ denotes the total number of directors on the board of directors. $BOD\_IND_{i,t}$ denotes the proportion of independent directors on the board of directors. $DUALITY_{i,t}$ denotes a dummy variable that equals 1 if the CEO is also the chairman of the board of directors and 0 otherwise. $Control_{i,t}$ represents the control variables; The industry fixed and year fixed have been included in the model; $\varepsilon_{i,t}$ is the residual term from the regression.

4.0 Empirical Test and Result Analysis

4.1 Descriptive Statistical Analysis of Variables

The outcomes of the descriptive analysis are shown in Table 2. LIT has a mean of 0.1647 and a median of 0.0000, with a high variance of 2.7991, suggesting that while the majority of firms experience minimal litigation risk, a small number are involved in substantial legal disputes. BOD_SIZE ranges from 0 to 17, with a mean of 8.34 and median of 9, indicating most firms comply with the 3–13 board size range under Company Law. BOD_IND ranges from 0.33 to 0.57 (mean 0.3787), showing all firms meet the one-third independent director requirement. DUALITY has a mean of 0.3255 and SD of 0.4686, suggesting considerable variation, with many firms separating CEO and chair roles for better governance. As shown in Table 3, correlations among variables are generally low, alleviating concerns about multicollinearity.

Table 2. The Descriptive Results

Variable	Min	Max	Median	Mean	SD	Variance
NUM_KAMs	1.0000	6.0000	2.0000	2.0306	0.6468	0.4184
LIT	0.0000	7.8861	0.0000	0.1647	0.4431	0.1963
BOD_SIZE	0.0000	17.000	9.0000	8.3422	1.6404	2.6910
BOD_IND	0.3300	0.5700	0.3636	0.3787	0.0535	0.0030
DUALITY	0.0000	1.0000	0.0000	0.3255	0.4686	0.2195
SIZE	17.545	28.637	22.153	22.328	1.3481	1.8174
LOSS	0.0000	1.0000	0.0000	0.1275	0.3336	0.1113
OWNCONC	2.4300	100.000	30.735	33.260	14.854	220.65
OREC	0.0000	0.8133	0.1076	0.1297	0.1088	0.0118
BIG 4	0.0000	1.0000	0.0000	0.0957	0.2942	0.0865

Table 3. Pearson Correlations among the Dependent Variable and Variables of Interest

Variable	NUM_KAMs	LIT	BOD_SIZE	BOD_IND	DUALITY	SIZE	LOSS	OWNCONC	OREC	BIG 4
NUM_KAMs	1									
LIT	0.010	1								
BOD_SIZE	.018*	-0.002	1							
BOD_IND	-0.011	0.015	-.529**	1						
DUALITY	.032**	-0.009	-.181**	.113**	1					
SIZE	.111**	-.052**	.280**	-0.008	-.165**	1				
LOSS	.079**	.091**	-.060**	.029**	.024**	-.121**	1			
OWNCONC	-.070**	-.026**	.042**	.042**	-.056**	.236**	-.144**	1		
OREC	.105**	0.015	-.098**	0.007	.065**	-.195**	.032**	-.132**	1	
BIG 4	-0.007	-.032**	.086**	.024**	-.052**	.332**	-.054**	.156**	-.087**	1

*** Correlation coefficients are significant at the 1 percent level or better, * Correlation coefficients are significant at the 5 percent level or better, two-tailed test.*

4.2 Results of The Regression Model

Table 4 presents the regression results examining the effect of litigation risk on the disclosure of KAMs. In Model (1), LIT has a positive and significant coefficient (0.018, $p < 0.05$), indicating that firms with higher litigation risk are more likely to disclose a greater number of KAMs. The result supports H1, suggesting that when clients face higher litigation risk, auditors are more motivated to invest greater effort in effectively auditing financial statements and monitoring the financial reporting system to avoid or mitigate potential reputational and financial losses that may arise from the client's legal liabilities (Sun & Liu, 2011).

Model (2) introduces board characteristics-related moderating variables and their interaction terms with litigation risk. The direct effect of LIT becomes substantially stronger (1.065, $p < 0.001$), suggesting that litigation risk remains a robust predictor of KAMs disclosure. The interaction term LIT × BOD_SIZE is positively significant (0.043, $p < 0.001$), implying that larger board size amplifies the effect of litigation risk on KAMs disclosure. This finding supports agency theory, suggesting that a larger board size reduces the likelihood of sustained collusion to conceal misreporting or financial fraud. A larger board also facilitates broader skill and knowledge exchange, increasing the likelihood of diverse insights and ultimately enhancing the quality of disclosure (Anderson et al., 2004).

In contrast, the interaction LIT × BOD_IND is negatively significant (-1.788, $p < 0.001$), indicating that greater board independence weakens the positive association between litigation risk and KAMs disclosure. Due to the potential reputational damage that independent directors may suffer when their firms become involved in litigation (Malm & Mobbs, 2014). Under high litigation risk, independent directors are likely to adopt a more conservative approach in monitoring financial reporting (Liu & Sun, 2022). Therefore, boards with a higher proportion of independent directors can enhance corporate governance by strengthening oversight and improving the financial reporting process. This reduces the risk of material misstatements, which may in turn lead auditors to disclose fewer KAMs. An alternative explanation is offered by (Xu, 2020), who argues that Chinese judges are deeply embedded in complex networks of political and economic interests. To mitigate the political uncertainty behind judicial rulings, judges tend to adopt risk-averse strategies and favor litigants with strong political backing, particularly those serving on corporate boards. Firms may appoint independent directors with legal or political connections to build strategic alliances (Lu et al., 2015). These relationships provide firms with rent-seeking opportunities and access to preferential legal treatment, allowing them to leverage directors' political and legal resources to exert influence over judges and shape favorable rulings (Lu et al., 2015). As a result, such dynamics may help firms minimize adverse legal outcomes, thereby reducing the need for auditors to disclose extensive KAMs.

The interaction with DUALITY is not significant. In China, the separation of the roles of CEO and board chair is not a mandatory requirement. Zhang et al. (2025) find that societal supervision plays a significant role in compelling firms to discipline underperforming or unfit CEOs. Listed companies penalized by the China Securities Regulatory Commission for securities fraud or integrity issues are more likely to dismiss their CEOs in order to preserve corporate reputation or mitigate broader reputational damage. This mechanism also acts as a deterrent to potential opportunistic behavior by CEOs. Moreover, neither the board chair nor the CEO is directly responsible for appointing or communicating with external auditors. These responsibilities fall under the purview of the audit committee, a subcommittee of the board, which oversees and evaluates the external audit process and coordinates it with internal audit activities. Therefore, the duality of CEO and board chair roles may have limited influence on the relationship between firm risk and the disclosure of KAMs.

Overall, the R-squared increases from 1.9% in Model (1) to 3.7% in Model (2), suggesting improved explanatory power with the inclusion of board characteristics variables. Both models include industry and year fixed effects, and the F-statistics indicate that the regressions are statistically significant at the 1% level.

Table 4. Regression of Litigation Risk on KAMs Disclosure

Variable	Model (1)	Model (2)
Constant	-0.865** (-2.21)	-0.362 (-0.90)
LIT	0.018** (2.29)	1.065*** (13.91)
BOD_SIZE		0.026*** (3.67)
BOD_IND		-0.752*** (-4.61)
DUALITY		-0.003 (-0.21)
LIT × BOD_SIZE		0.043*** (9.55)
LIT × BOD_IND		-1.788*** (-13.67)
LIT × DUALITY		-0.014 (-0.86)
SIZE	0.129*** (8.37)	0.131*** (8.53)
LOSS	0.077*** (5.74)	0.073*** (5.46)
OWNCONC	-0.001 (-0.66)	-0.001 (-0.67)
OREC	0.148 (1.45)	0.172* (1.71)
BIG 4	-0.182*** (-3.42)	-0.179*** (-3.40)
Industry Effect	Yes	Yes
Year Effect	Yes	Yes
R squared (%)	1.9	3.7
F-statistic	5.69 (0.0000)***	5.61 (0.0000)***
Total Observation	14679	14679

*This table reports the logistic regression. In each cell, the regression coefficient and Wald statistics in parentheses are reported in the upper and lower case, respectively. ***, **, and * denote the significance level of 1%, 5%, and 10%, respectively.*

5.0 Conclusions

Litigation risk has become a common and institutionalized practice for enterprises to resolve disputes through legal channels in China. This study investigates the relationship between litigation risk and the disclosure of KAMs in expanded audit reports. Based on panel data from 14,679 non-financial A-share listed firms (2017–2023), results show a significant positive association between litigation risk and the number of KAMs disclosed. Board characteristics moderate this relationship: board size strengthens it, the proportion of independent directors weakens it, and CEO duality shows no effect. These findings highlight the sensitivity of KAMs disclosure to litigation-related risks and the governance context in shaping audit reporting. This study extends KAM literature and emphasizes their role in enhancing audit transparency and investor protection. This study has certain limitations. The measurement of litigation risk does not distinguish between plaintiffs and defendants. China's legal environment, characterized by a civil law tradition, differs substantially from common law countries, and limit the extent to which the results can be generalized to other institutional settings.

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Paper Contribution to Related Field of Study

This paper contributes to the growing literature on Key Audit Matters by providing empirical evidence on the relationship between litigation risk and KAM disclosure in the context of China's civil law system. It is among the first to examine how firm-specific litigation risk influences auditors' disclosure behavior, revealing that auditors respond to heightened legal exposure by disclosing more KAMs. Furthermore, the study highlights the moderating role of corporate governance—particularly board size and independence—in shaping this relationship. By integrating perspectives from audit regulation, litigation risk, and governance, the study enhances our understanding of how KAMs function as a channel for communicating firm-specific risk and promoting audit transparency.

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