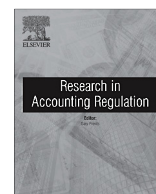
Research in Accounting Regulation 26 (2014) 1–11

Contents lists available at ScienceDirect

Research in Accounting Regulation

journal homepage: www.elsevier.com/locate/racreg



The Chinese experience: The impact of financial restatements on firm value and its implications on the investigatory practices of regulators

Chen Ma [a], Michael Kraten [b,*], Junrui Zhang [a], Peng Wang [c]

[a] School of Management, Xi'an Jiaotong University, China
[b] School of Business, Providence College, United States
[c] Business School, Xi'an International Studies University, China

ARTICLE INFO

Article history:
Available online 12 March 2014

Keywords:
Core account restatements
Financial restatements
Firm value
Prior period adjustments
Regulatory practices

ABSTRACT

We examine the relationship between restatements of prior period financial results and firm value in China. This relationship is relevant to the millions of global investors who purchase Chinese equity securities because Chinese regulatory authorities must focus on the restatement events that, in their judgment, most warrant investigation. We recommend that they focus their attention on restatement announcements (and the firms that announce them) that possess the characteristics that most impact firm value.

Prior studies of the American equity markets found evidence of a relationship between the nature of the restatement announcements and firm value, as well as evidence that core account adjustments and high-magnitude adjustments affect firm value more than non-core account adjustments and low-magnitude adjustments. However, based on a sample of Chinese listed firms that made corporate announcements that appeared in the Asian press between 2003 and 2011, we only find mixed evidence in the Chinese equity markets in support of the former relationship, and no evidence at all in support of the latter relationship.

In other words, restatement announcements in China do not impact firm value to the same extent, and in the same manner, as restatement announcements in America. Chinese regulators must thus develop policies that are unique to the Chinese markets in order to effectively prioritize their oversight activities on firms that issue restatement announcements.

What factors should be considered by Chinese regulators? We identify a collection of corporate governance variables, as well as a smaller collection of financial variables, that are significantly associated with decreases in firm value. We also develop a set of regression analyses that utilize these variables to explain a significant portion of the variability of firm value during the sample period. Interestingly, however, we find no evidence that the growth patterns of the firms are significantly associated with changes in firm value.

Using this evidence, we recommend the development of a model of regulatory guidance that is customized for the unique characteristics of the Chinese equity markets. We believe that this model can help Chinese authorities focus their attention on specific restatement announcements that most impact firm value.

© 2014 Elsevier Ltd. All rights reserved.

* Corresponding author. Tel.: +1 401 865 1625.
E-mail address: mkraten@providence.edu (M. Kraten).

http://dx.doi.org/10.1016/j.racreg.2014.02.001
1052-0457/© 2014 Elsevier Ltd. All rights reserved.

Introduction

Motivation

Should government regulators attempt to investigate *all* restatements of previously issued financial statements (i.e. all prior period adjustments) that are announced by publicly traded firms?

In theory, an extremely vigilant regulatory organization with an unlimited array of resources might be tempted to do so. After all, a restatement represents a de facto admission that a previously released set of financial statements contained inaccurate information. And when investors rely on inaccurate information, they are often misled into making equity trading decisions that are not in their best interests. Thus, regulators possess the justification, and the authority, to launch investigations into any and all such restatements.

However, no regulatory organization is blessed with an unlimited array of resources. Regulators must thus prioritize the restatement events that most warrant investigation. But how should regulators establish such priorities? In other words, how should they develop internal guidelines that help them focus their limited resources on the prior period adjustments that cause the most harm to shareholders?

This study presents findings that address these questions, focusing explicitly on the equity markets of the People's Republic of China. Because of China's recent dramatic growth within the world economy, and given the massive amount of global funds that have been invested in the Chinese market during the past decade, we believe that our findings involving the Chinese equity markets can help protect the public interest of the entire international financial community. Furthermore, because China's regulatory system is now proceeding through a developmental stage, we believe that the time is ripe for academic researchers to study this issue and develop appropriate recommendations.

Approach

Consistent with the prior research literature, we define the market value of the Chinese firms' publicly traded "Class A" stock as the primary indicator of investor wealth. Thus, restatements that are associated with decreases in the firms' stock market values are defined as prior period adjustments that harm shareholder interests. The stronger the association between a restatement announcement and the firms' subsequent decrease in value, the stronger the implication that the restatement has harmed shareholder interests, and thus the higher the priority that regulators should dedicate to investigating the prior period adjustments.

An extensive stream of research literature has established that restatements by American firms are indeed associated with decreases in firm value under certain, though not all, conditions (Anderson & Yohn, 2002; Myers, Scholz and Sharp, 2010; Palmrose, Richardson, & Scholz, 2004); some recent research has produced similar findings for Chinese firms as well (Wei, Li, & Wang, 2009). Researchers have also established that restatements of core accounts (defined as accounts that primarily affect operating revenues and expenses, and thus operating earnings) damage shareholder interests more extensively than restatements of noncore accounts under certain, though not all, conditions (Anderson & Yohn, 2002; Lev, Ryan, & Wu, 2008; Park & Wu, 2009; Wei et al., 2009), and that restatements that decrease prior period income are more damaging than restatements that increase prior period income (Lev et al., 2008; Palmrose et al., 2004; Wei et al., 2009).

We segment all corporate announcements that appeared on an authoritative Chinese market information web site between 2003 and 2011 into six groups of announcements: (a) announcements that are *unrelated to* prior period restatements, (b) restatement announcements that *do not* affect prior period income, (c) restatement announcements, primarily affecting *core* accounts, that result in *higher* prior period income, (d) restatement announcements, primarily affecting *noncore* accounts, that result in *higher* prior period income, (e) restatement announcements, primarily affecting *core* accounts, that result in *lower* prior period income, and (f) restatement announcements, primarily affecting *noncore* accounts, that result in *lower* prior period income. Then we replicate prior research studies in order to confirm (or disconfirm): (a) whether restatement announcements significantly impact firm equity value, (b) whether there is a significant difference in the impact of core account restatements versus the impact of noncore account restatements, and (c) whether there is a significant difference in the impact of Income Decreasing Restatements (IDRs) versus the impact of Income Increasing Restatements (IIRs).

Finally, after confirming or disconfirming these hypotheses, we examine a collection of supplemental corporate governance and financial variables that also appear to impact firm equity value. These variables support the development of a regulatory model that can be utilized to prioritize prior period adjustments for investigation.

Findings

Prior studies found evidence of a relationship between the nature of the restatement announcements and firm value, as well as evidence that core account adjustments and high-magnitude adjustments affect firm value more than noncore account adjustments and low-magnitude adjustments. However, based on a sample of Chinese listed firms that made corporate announcements that appeared in the Asian press between 2003 and 2011, we only find mixed evidence in support of the former relationship, and no evidence in support of the latter relationship.

We then identify a collection of corporate governance variables, as well as a smaller collection of financial variables, that are significantly associated with decreases in firm value. We also develop a set of regression analyses that utilize these variables to explain a significant portion of the variability of firm value during the sample period.

Furthermore, we find that the growth patterns of the firms are not significantly associated with decreases in firm equity value for any of the groups of announcements,

Download English Version:

https://daneshyari.com/en/article/1006664

Download Persian Version:

https://daneshyari.com/article/1006664

Daneshyari.com