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Accounting restatements and audit quality in China

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ABSTRACT

This paper examines the effect of audit quality on accounting restatements in China. Evidence on the determinants and consequences of accounting restatements in emerging markets is scant, although these countries are more vulnerable to financial report manipulation and subsequent restatements. For accounting restatement analysis we regress non-cash flow restatement observations and cash flow restatement observations on audit quality and restatement–audit quality interaction variables. Earnings manipulation increases the likelihood of non-cash flow restatement observations, but high quality audit constrains this effect. However, no such evidence is found for cash flow restatements.

1. Introduction

The dramatic increase in accounting restatements has attracted a considerable amount of academic, regulatory and public interest, given their undesirable consequences. A restatement represents an acknowledgement by the firm of a material omission or misstatement in their financial statements (Palmrose & Scholz, 2004). Firms restating financial statements have suffered substantial losses in market values (Palmrose, Richardson, & Scholz, 2004), increases in the cost of capital (Hribar & Jenkins, 2004), and high executive turnover (Hennes, Leone, & Miller, 2008; Srinivasan, 2005). Restatements call into question the credibility of a firm's future financial reports, because of its previously released low quality financial information. This increase in accounting restatements, and consequent shareholder losses, has drawn substantial public scrutiny of auditors' roles in ensuring the quality of financial statements (Romanus, Maher, & Fleming, 2008).

External auditors perform a critical role in establishing the credibility of financial statements by providing independent assurance to corporate stakeholders about the statements' integrity. Auditing also plays a significant role in enforcing and protecting investors' rights by detecting expropriation by insiders (Newman, Patterson, & Smith, 2005). Scrutiny of the audit profession following the dramatic increase in accounting restatements is not surprising, as external auditors' failure to detect a misstatement has been identified as one of the primary factors contributing to the increase in restatements (Eilifsen & Messier, 2000). Failure of audit in preventing misstatements in financial reports can be due to either the auditor's failure to perform his/her job, limitations of the audit function itself, or both. This argument suggests a negative relationship between audit quality and the likelihood of accounting restatements, as confirmed by Romanus et al. (2008) who find that industry specialist auditors reduce the likelihood of restatements affecting core operating accounts. However, other studies find weaker support for audit quality to reduce the likelihood of restatement (Agrawal & Chadha, 2005; Lin, Li, & Yang, 2006).

This paper examines the association between audit quality and accounting restatements in China. China is an interesting setting in which to examine audit quality for a number of reasons. First, the Chinese audit market is very competitive due to the active participation of numerous small and medium-sized audit firms, in contrast to other Western audit markets which are dominated by the Big 4 audit firms. Second, the financial reporting environment in China has historically been dominated by state ownership, political interference and suppression of bad news, inhibiting the growth of an independent audit profession (Piotroski & Wang, 2012).

Our investigation on the effect of audit quality on accounting restatements considers both non-cash flow restatements (hereafter NCFREST) originating from accruals management affecting income statement and balance sheet items, and cash flow restatements (hereafter CFREST) originating from cash flow manipulation. Classifying restatements into different groups is important, because auditors' litigation risks differ in the presence of different types of restatements (e.g., economic versus technical restatements) (Palmrose & Scholz, 2004). Existing research finds that high quality auditors constrain managerial opportunistic accruals management behaviour (Becker, DeFond, Jiambalvo, & Subramanyam, 1998;

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Chen, Chen, Lobo, & Wang, 2011). In additional to accruals management, the recent cash flow management literature finds that firms also manipulate their cash flow information (Lee, 2012; Zhang, 2009), which challenges the traditional belief that cash is free of manipulation and thus can be used to gauge the credibility of earnings (Wild, Subramanyam, & Hasley, 2004). Despite this evidence, the monitoring function of auditors has remained unexplored both internationally as well as in China, specifically around constraining cash flow management. Thus, our paper attempts to address this issue. Investigating auditors' monitoring of both types of financial reporting manipulation is important because both accruals and cash flow from operations are used for contracting and valuation decisions.

Specifically, we argue that auditors' monitoring effectiveness is likely to be more prominent for NCFREST and no such expectation is made of CFREST. This argument is based on the observation that auditors are likely to be subject to intense scrutiny by regulatory authorities for failing to detect NCFREST cases (involving earnings restatements), as investors use information about current and potential earnings for investment decision making (Graham, Harvey, & Rajgopal, 2005). In the context of China, Firth, Lo, and Wong (2005) find that the Chinese Securities Regulatory Commission (hereafter CSRC) is more likely to sanction auditors if they fail to detect and report material misstatement fraud such as overstatement of assets or income, understatement of liabilities or expenses. For material misstatement fraud, auditors are more likely to be sanctioned for failing to detect revenue related misstatements. In contrast, there is little evidence of auditors being sanctioned over severe cash flow-related fraud.

To determine whether high quality audit differentially impacts on NCFREST and CFREST, we separately regress the restatement incidence (NCFREST versus CFREST) on audit firm size, earnings management (cash flow management) and a number of control variables. Consistent with prior research, we use audit firm revenue as a proxy for audit quality and identify the Top 8 largest audit firms as high quality auditors and all other audit firms as low quality auditors (Chen et al., 2011; DeAngelo, 1981). The results suggest that high quality audit indeed reduces the likelihood of earnings management-induced restatements, but this monitoring effect of high quality audit is absent for cash flow management-induced restatements.

This study contributes to the existing research on accounting restatements in a number of ways. First, unlike other Chinese restatement studies (Wang & Wu, 2011; Zhizhong, Juan, Yanzhi, & Wenli, 2011) that consider restatements generally, we categorise restatements into earnings-related and cash flow-related restatements and provide theoretical arguments for predicting auditor monitoring on these two types of restatements. We contribute to the restatement literature by providing a classification of restatements from an earnings-related and cash flow-related opportunistic reporting perspective. Second, we explore the audit monitoring function on cash flow management as a form of opportunistic reporting that is newly identified by the literature. Our investigation, despite being exploratory, highlights auditors' lack of awareness of cash flow management. To the best of our knowledge, our study is the first to examine the effect of high quality audit on restatements related to cash flow management. Therefore, our paper adds to the cash flow management literature.

Lastly, the findings of this paper enrich the understanding of the role of auditing as a governance mechanism in an economy dominated by government ownership. Historically, the value of external auditing for ensuring credible financial reporting in China has been undermined, in that most Chinese audit firms had affiliations with government agencies, government-sponsored bodies, universities or research institutions, making those firms vulnerable to political pressure. However, in recent years, there has been sustained progress in market-based and contracting-based incentives for financial reporting transparency (Piotroski & Wang, 2012) increasing the demand for high quality audit.[1] Our evidence that high quality audit constrains earnings manipulation-related restatements is an important addition to the Chinese auditing literature. The results provide some confidence in the informational value of external auditing in China, indicating audit profession's contribution to the progression of transparency in the financial reporting environment.

2. Relevant literature and development of hypotheses

2.1. Literature survey

Eilifsen and Messier (2000) recognize four conditions that must be met for audited financial statements to be subsequently restated: (i) a material misstatement resulting from some types of inherent risk exists (e.g., management's aggressive accounting practices, misapplication of GAAP, and so forth); (ii) the misstatement has not been prevented or detected by the company's internal control; (iii) the external auditor has failed to detect the misstatement and therefore misstated financial statements are issued; and (iv) the misstatement is subsequently discovered and, if deemed material, requires the correction, restatement, and reissue of the original financial statements. Therefore, it is clear that a restatement meeting the above conditions suggests a breakdown of a company's internal control and external auditing. The SEC considers restatements to be audit failures and, in line with this assertion, research indicates that restatements increase the risk of securities class action lawsuits including lawsuits against auditors (Fuerman, 1997).

According to professional auditing standards, auditors are tasked with planning and performing an audit in order to obtain reasonable assurance that the financial statements are free of material misstatements (Public Company Accounting Oversight Board (PCAOB), 2010). To accomplish this task, auditors plan the nature, timing and extent of audit procedures after considering, among other factors, the degree of risk of material misstatement in financial reporting. This suggests a negative relationship between audit quality and the likelihood of accounting restatements. Romanus et al. (2008) find that auditor industry specialization reduces the likelihood of issuing restatements affecting core operating accounts, suggesting that industry specialization adds value in auditing a particularly critical area of the firms' continuing operations. In addition, they find that changing from a non-specialist to a specialist auditor increases the likelihood of restatement, and changing from a specialist to a non-specialist reduces the likelihood of restatement. Their findings are consistent with industry specialization enhancing auditors' role in improving the quality of the financial reporting process, particularly related to the core operations of their clients. However, Agrawal and Chadha (2005) fail to find any significant relationship between audit quality (proxied by Big 5/non-Big 5 audit groups) and accounting restatements. Lin et al. (2006) even find a positive association between audit quality and restatements, indicating that large and

[1] Chen et al. (2011) find support for this proposition as they document lower cost of equity capital for a subset of firms audited by Top 8 auditors. Gul, K, and Qiu (2010) find that high quality audit improves dissemination of more firm-specific information and reduces stock price synchronicity. Wang and Iqbal (2009) find evidence of Big 4 premiums for brand name as well as industry specialization in both the statutory and supplementary markets. Sami and Zhou (2008) and Zhou (2007) find that subsequent to the implementation of the new auditing standards in 1996 in China, listed companies experienced a significant increase in trading volume and accounting information quality as evidenced by reduced earnings management and decreased stock price synchronicity. Chen, Chi, and Lin (2012) find that client importance at the audit-office level impairs audit quality but only for small offices of non-Big 4 audit firms. Gul, Sun, and Tsui (2003) provide evidence that the market positively valued the earnings of firms audited by local Top 10 firms in the Shanghai stock market.

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