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Financial Restatement Research Literature Review

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Abstract

In recent years, listed companies have become more and more common about financial statement restatement due to erroneous or misleading information in previously published financial reports. Financial restatement has also become a hot topic in accounting research. Through reviewing the financial statement restatement in recent years, the paper summarizes the causes and consequences of the financial statement restatement, the influencing factors of financial restatement, and the reaction of the company after financial restatement, hoping to be able to list listed companies in China's emerging transition market. It is helpful to improve the quality of accounting information.

Keywords

Accounting Information, Financial Report, Financial Statement Restatement

1. Introduction

If the capital market is aimed to continue to develop steadily, it will be inseparable from all kinds of relevant accounting information disclosed by the company. The annual financial report disclosed by the listed company is an important part of these related accounting informations. The main way for external investors, creditors and other stakeholders to obtain company information is to read the company's financial reports. Users rely on the information provided by financial reports to predict the company's future profitability and evaluate the company's value, making investment decisions. Therefore, the reliability of the information will directly affect the decision of the reporting user. High-quality financial information is an important foundation for the capital market. It can help information users make correct investment decisions, thus facilitating effective resource allocation in the capital market. Low-quality information can mislead investors' decisions and reduce the effectiveness of capital market resource allocation. Then, in recent years, it has become more common for listed companies to restate financial statements because of misinformation or misleading information in previously published financial reports [1]. Foreign scholars have conducted extensive research on financial statement restatement and have made many thought-provoking research results. With the rapid development of China's capital market, the phenomenon of financial statement restatement in domestic listed companies is also increasing. Domestic scholars' research on financial restatement is also deepening. Financial statement restatement means that the financial information is provided before is untrue. The financial restatement reduces the quality of financial reports, thus misleading information users to make investment decisions, which seriously affects the efficiency of resource allocation in the capital market. Based on this, this paper is a systematic review of the recent literature research financial statement restatement at home and abroad, hoping to sort out the research status of financial statement restatement.

Financial statement restatement is the restatement of the financial statements, referring to the restatement of previously published financial reports when the company discovers and corrects errors in the previous financial reports. First, this paper analyzes the reasons for the company's financial statement restatement, and finds that the inherent risks, control risks and inspection risks are the main reasons for financial restatement; then enumerates the various factors affecting the financial statement restatement, and finds that factors such as independent directors or audit committee, company size, asset-liability ratio, growth, profitability and accruals will affect the financial statement restatement. Then it summarizes the economic consequences of the financial statement restatement and finds that financial restatements are bad news for investors, creditors, analysts and auditors. Finally, the company's reaction to the restatement of the financial statements was studied. It was found that after the restatement, the company would adopt reputation reconstruction measures, dismiss the auditors, have audit opinion purchase behavior, and disclose more MD&A non-financial information.

2. The Reasons for Financial Statement Restatement

The restatement of the company's financial statements indicates that the audit failed and the auditor's audit risk increased. Audit risk is that the auditor has issued an inappropriate opinion when the financial report has a material misstatement. Audit risk is consisted of material misstatement risk and check risk, while the material misstatement risk is consisted of inherent risk and control risk. Therefore, the reasons for the financial statement restatement include the inherent risks, control risks and inspection risks.

Intrinsic risk refers to accounting complexity, including business complexity and complexity of the rules. When accounting complexity is high, managers may make mistakes when applying accounting standards, thereby increasing the possibility of unintentional misstatement; or increasing the likelihood of allowing management to manipulate financial reporting increases the likelihood of intentional misstatement [2], and the increase in inherent risks increases the likelihood of financial statement restatement. Plumlee and Yohn [3] argue that in addition to accounting fraud, other overvalued earnings restatements should be attributed to unintentional accounting errors and misunderstandings of increasingly complex accounting standards.

Control risk refers to the company's internal control level. When the company's internal control level is low, there are major defects or can't effectively play the role of internal control, the wrong cons will enter the company's financial reporting system, and the risk will come into being. This will result in a higher likelihood of the financial statement restatement. Guo *et al.* [4] considers the relationship between the effectiveness of internal control and financial statement restatement from the employee policy. They found that the friendly employee policy will reduce the major defects related to employees, reduce errors, and significantly mitigate the impact of internal control invalidation. So that it will reduce the possibility of financial restatement. Cao Qiang [5] analyzed the reasons for the financial statement restatement of Chinese listed companies. The study found that the company's internal control defects are the most important reasons for financial restatement. Other reasons include management's earnings manipulation and accounting, the ambiguity of the guidelines and the complexity of the business process. Yuan Min [6], based on the case analysis of Dell, linked the financial statement restatement with the major defects in the internal control of financial reporting. She also believed that the major flaw in the internal control of financial reporting was the reason for financial restatement. Financial restatement should be considered as an internal control with significant defects and they should be disclosed accordingly in the report.

Checking the risk refers to the auditing efforts of the auditor. The auditor will use the auditing effort to cope with the increased risk of misstatement, thereby reducing the possibility of unrecognized misreports. When the auditor effort increases, it will reduce the risk of checking and reduce the financial statements. Romanus *et al.* [7] found that the auditor's industry expertise is mainly to reduce the accounting restatement affecting the core account. When the auditor is replaced by non-industry expertise to have industry expertise, the probability of accounting restatement will increase. On the contrary it will reduce the occurrence of restatements. Lobo and Zhao [8] used audit fees to measure audit efforts and found that the higher the audit fees of auditors, the more likely they can find errors in financial reports, thereby reducing the likelihood of financial statement restatement. China's "Guidelines for Internal Control Auditing of Enterprises" issued in 2010 clearly requires that internal control audits is implemented on the Shanghai Stock Exchange and the listed companies on the Main Board of the Shenzhen Stock Exchange from January 1, 2012. Internal control auditing, like the audit of financial statements, has gradually become a mandatory requirement of the state and a statutory responsibility of listed companies. Zhen Wei *et al.* [9] from the perspective of internal control auditing, empirically found that the integrated audit of internal control audit and financial statement audit can improve the audit quality of financial statements, reduce the occurrence of financial statement restatement, internal control costs and audit fees. The higher the internal control cost and total audit cost, the lower the possibility of financial restatement.

3. The Factors Affecting Financial Statement Restatement

The existing literature mainly examines the characteristics of independent directors or audit committees, and proves the impact of corporate governance efficiency on accounting restatement. Abbott *et al.* [10] have shown that the higher the independence of the audit committee, the more diligent it is, and the fact that at least one member has a financial background; the less likely it is to restate it. Agrawal and Chadha [11] examined the regulatory role of the company's board of directors and the audit committee with independent financial background directors, and found that it helped to reduce the positive impact of accounting restatements. The number of part-times of independent directors of listed companies in China and the establishment of the audit committee and the important duties of the chairman are significantly related to the financial statement restatement (Yang Zhonglian and Yang Zhenhui, 2006). Ma Jia (2013) also confirmed that the better corporate governance, the less likely the company is to restate financial statements.

Company size, asset-liability ratio, growth, profitability, and accrual items also have an impact on financial statement restatement. Generally speaking, companies with large scales have higher credibility and information disclosure is more transparent, and the possibility of financial restatement is smaller, but the empirical results have no unified results. Burns and Kedia [12] used market value to measure the size of the company and found that large companies were more likely to have financial restatements. Palmrose *et al.* [13], Ahmed, and Goodwin [14] found that small-scale companies are more likely to have financial restatements. For companies with high asset-liability ratios, managers face pressures to increase revenues and improve financial performance, which is prone to financial restatement [15]. Poor growth means that there are problems in the corporate governance structure and the risks faced by the operation. It may not follow the accounting standards and relevant laws and regulations very well, and it is more likely to restate the financial statements. On the other hand, companies with continued earnings growth will face pressure to maintain earnings growth, and these companies are more likely to have financial restatements. Ahmed and Goodwin [14] used Australian companies' data to find that companies with good growth are more likely to have financial restatements.

Cao *et al.* [5] analyzed the role of reputational mechanisms in financial restatement. They used the rankings of the "most admired companies in the United States" by Fortune Magazine to measure their reputation and found that companies with better reputations had fewer. The accounting restatement indicates that the company's reputation has played a role in restricting the mechanism.

Dai Yiyi *et al.* (2011) also found that media negative reports can effectively curb the occurrence of accounting restatements. The conclusions show that media supervision has a restrictive function on financial statement restatement.

4. The Consequences of Financial Statement Restatement

The financial statement restatement refers to the behavior of the listed company to restate the previously published financial report while discovering and correcting the errors in the previous financial report. When the current financial report is found to be in error or flawed, the listed company can take the initiative to make corresponding financial supplements or amendments, or it can be made according to the requirements of the auditor or regulatory department in the subsequent accounting period. The reason for these errors or information omissions is due to the technical errors of accountants, such as the errors in the entry of digital and text information, and the correction of major information errors caused by the management of listed companies.

So far, a large number of literatures at home and abroad have studied the economic consequences of financial statement restatement. Financial statement restatement is a bad news for investors, creditors, analysts and auditors.

First, financial statement restatement by listed companies is bad news for equity investors. Investors use financial reports to understand the company's current operating conditions, predict the company's future profitability and evaluate the company's value. When the company restates the financial statements, it indicates that the information in the financial report provided by the company is distorted. This makes investors uncertain about the company's current and future financial reporting reliability, and concerns about the company's future profitability, resulting in negative market returns and reduced company value. The empirical results of Anderson and Yohn [15] and Nguyen and Puri [16] also prove that the share price will drop significantly after the financial restatement announcement, resulting in a significant negative abnormal return. Hribar and Jenkins [17] found that restatement would lead to a decline in the company's expected future earnings and increase the company's cost of equity capital. According to different value models, the cost of equity capital would increase by an average of 7% within one month after the financial restatement 9%, and the higher the company's financial bar, the higher the cost of equity capital. When restatement increases the company's uncertainty and risk, investors will require a higher rate of return to compensate for the future risk and increase the company's cost of capital. Wilson [18] and Chen *et al.* [19] confirmed from the restatement of the content of earnings information that the company's earnings response coefficient will be significantly reduced after the financial statements are restated, which means that investors' confidence in the financial information system is received. The effect of restatement is reduced. The difference is that the former finds that the impact of restatement is short-lived, while the latter finds that the impact of restatement on investor confidence is long-term. Kravet *et al.* [20], Nguyen and Puri [16] found from the perspective of information risk and information asymmetry that the company's information risk factors and information asymmetry will increase significantly after financial restatement, reducing investors' future development of the company. Prospects for expectations will re-evaluate financial reporting information, require larger bid-ask spreads, and increase information costs. Domestic scholars have also confirmed the negative effects of financial statement restatement on investors based on China's data. Zhang Ruoqin and Liu Bingfu (2008), Yu Lifang (2007) found that after the financial restatement, the company's share price will fall sharply, the image will be damaged, investor confidence will fall, capital costs will increase, and litigation will increase. Wei Zhihua *et al.* [21] found on the basis of subdividing the type of restatement of the annual report, correcting the announcement, restatement due to accounting problems, restatement of core accounting indicators or lowering the company's earnings, restatement involving multiple accounting when the annual and restatement news is bad news, the market reaction is significantly negative. He Jiangang and Wei Minghai [22] also found that the financial statement restatement led to an increase in market risk and uncertainty. Listed companies recounted the stock price decline during the announcement period, and the market's accumulated excess returns were significantly unresolved. It shows that financial statement restatement reflects the quality of accounting information lacking reliability and transparency, which increases the risk and uncertainty of future decision-making of investors. Zhao Yanbing and Li Qingyuan [23] used the standard deviation of the company's weekly excess return rate to measure the heterogeneity risk, and then proceeded to consider the impact of financial statement restatement on information asymmetry. They found that the financial statement restates the company's stock return heterogeneity risk significantly higher than the financial statement restatement. It also finds that the financial statement restates the company's product market competition performance and its securities market performance is significantly lower than the non-period financial statements. Restate the company, which means that the financial restatement increases the information asymmetry between the company and the investors in the market, and increases the standard deviation of the company's stock weekly excess return.

Second, the impact of financial statement restatement by listed companies on creditors is negative. Stocks and bonds are the two most basic types of securities. The risks and uncertainties brought about by restatements have different effects on shareholders and creditors. Restatement will change the company's historical surplus and reduce investors' expectations of future cash flows, thereby reducing the company's total value. Restatement will also increase the information risk of the company's operations and increase the liquidity of the company's assets, so the restatement should be negatively correlated with the value of the bonds. The empirical results of Shi and Zhang [24] also confirmed that the bond price reaction of the company after the financial restatement is negative, and the issuance of new bonds will have a higher additional risk premium, and the bondholders will re-evaluate the value of the assets in the financial report after restatement.

Bank loans are an important channel for corporate finance, so banks have also become one of the company's important creditors. Graham *et al.* [25] studied the impact of restatement on bank loan contracts. They found that loans after the company's financial restatement would have significantly higher spreads, shorter maturities, more guarantees and contracts. There will be more restrictions. And the borrower for each loan will be reduced and the company will pay a higher financial fee. The more serious the financial restatement of the company, the more the debt costs increase. This shows that restatement weakens creditors' confidence in the company's disclosure reliability, and banks will use more stringent loan contracts to customer service restatement risks. Chen *et al.* [26] also found that the external financing obtained by the company after the restatement will drop significantly, especially those companies with significant misstatement. And after restatement, the company relies more on debt financing than on equity financing, especially private debt financing. Because restatement reduces information reliability and increases information asymmetry, companies will be less likely to obtain creditor investment, but information asymmetry has less impact on debt financing than equity financing, and all restatement of corporate debt financing will more than equity financing. Domestic scholars Yu Jianqiao and Wang Wei [1] based on Chinese data found that the overall level of debt financing of listed companies in China after financial statement restatement will not change significantly compared with the previous period. However, when distinguishing between state-owned enterprises and private enterprises according to the nature of ownership, it is found that the financial restatement significantly reduces the financing level of private enterprises' debts, and the financial restatement of inflated profits and that would allow creditors to scale back credit further.

Third, financial statement restatement by listed companies is also a bad news for analysts. Analysts need to make financial statements from financial reports to make a predictive analysis of the company's future earnings. When the company restates, it indicates that the reliability of financial information is greatly reduced. It needs to make downward revisions to the previous year's surplus. On the one hand, it will affect the analyst's earnings forecast based on the previous annual surplus, and the corresponding earnings forecast will also be corresponding. The next revision, which reduces future expected cash flow and reduces corporate value. On the one hand, it affects analysts' confidence in the reliability of financial reporting and increases the dispersibility of analysts' future earnings forecasts [17]. Palmrose [13], Frieder and Shanthin Kumar [27] also found that after the financial statement restatement, analysts predicted that the differences will increase significantly, and the earnings forecast will also be significantly adjusted downward. Domestic scholar Ma Chen *et al.* [28] used the data of listed companies in China, and also found that financial statement restatement will reduce analysts' follow-up and increase analysts' forecasting errors, and the bigger the restatement of previous year's profits and losses, the greater the analyst differences and errors, analysts are no longer optimistic about the company's prospects.

Finally, financial statement restatement by listed companies is negative for auditors. The auditor plays an important role in assessing the integrity of the audit report. Restatement means that there is an error in the financial report audited by the auditor, indicating a reduction in audit quality. As a result, shareholders have doubts about the auditor's ability to monitor the company's future financial reporting, and believe that the auditor should be responsible for the financial restatement. Hennes *et al.* [29] also found that the company is more inclined to dismiss the auditor when the company has a serious financial restatement, and the market's response to the dismissal is positive. Therefore, the external auditor will increase the auditing effort in response to the risks brought by the restatement. In the audit of the company's financial report, the project will be examined more carefully to reduce the possibility of financial restatement, which will require higher audit fees and increase. The company's audit costs [8]. Domestic research also shows that financial restatement is also bad for auditors. Cao Qiang *et al.* [30] verified from financial statement restatement that the financial statement restatement would affect the auditors' rigorous audit opinions on customers and found that if the customer's financial restatement belongs to management into earnings manipulation, then the client importance and the likelihood of an auditor issuing a strict audit opinion on the financial restatement company will change from negative to irrelevant. It means that the auditor regards the financial restatement as a bad news and they can identify the nature of the risks contained in the financial statement restatement. Increasing the possibility of issuing a severe audit opinion to customers has a negative impact on the company.

5. The Company's Response after the Financial Restatement

The company's restatement of financial statements is bad news for investors, creditors, analysts, and auditors, all of which have economic consequences. And these consequences will eventually turn into an adverse impact on the company. After the financial statement restatement, the company not only faces tangible damages such as falling stock prices, falling value, rising capital costs, and weakened financing capacity, but more importantly, the intangible harm to the company. After the restatement, the company's reputation and image are damaged, and the public's trust is declining, which hinders the company's long-term development in the future. Therefore, after the financial statements are restated, the company will inevitably respond and take measures.

Chakravarthy *et al.* [31] found that after financial restatement the company had significant incentives to rebuild reputations for multiple stakeholders including capital providers, customers, employees, authorities, etc., and reputation reconstruction measures also generate positive markets return. Those who restate the frequency and share price of the reconstruction measures taken by the company in the post-restatement period will be even greater, and the companies with more measures will have a significantly higher earnings response coefficient. Hennes *et al.* [29] found that the company's board of directors is more likely to dismiss the auditor after the financial statement restatement, and the more serious restatement of the company's probability of dismissing the auditor. And after the dismissal, the market's response was positive, and the positive response to the more serious restatement became more apparent. Domestic scholar Ma Chen *et al.* [28] also verified the dismissal of the accounting firm after the financial statement was re-stated, and found that the frequency of the dismissal of the accounting firm was significantly higher in the financial restatement company within one year after the financial restatement. And further found that the fraud-related restatement company changed the firm to a more reputable firm after the financial restatement, and the error-related restatement company changed to a more submissive firm after the financial restatement. This indicates that the company's financial restatement is more serious in the company's replacement of the firm mainly to restore its damaged reputation and image. Li Qingyuan and Zhao Yanbing [32] verified that the company had purchased audit opinions in order to obtain standard audit opinions after the financial restatement from the perspective of the audit opinion purchase after the financial restatement. After the financial restatement, the purchase of audit opinions was more serious in one year, and the means of purchase became more and more secret to avoid the supervision of the regulatory authorities and the public. They are used to increasing the audit fees of the current auditors. And the weekly excess return rate fluctuations are relatively stable. This shows that after the financial restatement, the company will successfully escape the eyes of the regulatory authorities and investors by the secret means of increasing the audit fees of the current auditors to achieve the purpose of successfully purchasing audit opinions. Cheng Xinsheng *et al.* [33] studied whether the executives used the management discussion and analysis (MD&A) non-financial information perspective and found that the financial restatement of the company in the earnings manipulation year and the restatement period of MD&A non-financial information in the MD&A after the disclosure was higher than the earnings restatement, the company that performed the surplus restatement disclosed more MD&A non-financial information than the company that did not restate the surplus. The above research shows that the company will take measures to alleviate the consequences of restatement after the financial restatement.

6. Conclusion

Despite the increasingly strict market supervision environment, the financial statement restatement, one of the accounting trust crises, still exists and does not seem to be effectively curbed. On the contrary, due to the increased uncertainty and risks of the information environment and the close attention and strict scrutiny from investors, media and regulators, it naturally became a hot topic in accounting research. By reviewing the financial statement restatement in domestic and foreign countries in recent years, this paper summarizes the antecedents and consequences of financial statement restatement, the influencing factors of financial restatement, and the reaction of the company after financial restatement, and has a further understanding of financial statement restatement. Due to the inherent risks, control risks and inspection risks, listed companies restate financial statements, which will have serious economic consequences. These are bad news for investors, creditors, auditors and analysts. The negative impact of the market will eventually turn into an adverse impact on the company. Therefore, after the financial restatement, the listed company will adopt response measures such as rebuilding the reputation, dismissing the auditor, and purchasing the audit opinion. China is in the environment of emerging transition market, and the financial statement restatement should be highly valued. This paper, through combing the financial restatement literature, hopes to provide certain measures for the regulatory authorities, auditors and companies to reduce financial statement restatement.

Conflicts of Interest

The author declares no conflicts of interest regarding the publication of this paper.

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