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Non-audit Services, Audit Quality, and Financial Statement Restatements: Evidence from Chinese Listed Companies

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ABSTRACT

This study examines the relationship between the provision of non-audit service (NAS) and financial statement restatements (FSR) among companies in China. Concerns were raised that the provision of NAS to the same audit clients is more likely to result in a restatement of financial statements. This study also tests the direct and moderating effect of audit quality (AQ), measured as Big 4 and Local Top-10 on the relationship between the provision of NAS and the restatement of financial statements. The China localization policy among international audit firms increases the importance of exploring the impact on NAS and FSR. This study analyzes the sample of 13,676 observations for the period of 2010 to 2021 from China-listed companies. The study found that the provision of NAS was more likely to restate the financial statements, which is consistent with the belief that the provision of NAS compromises audit independence. The study finds that Big 4 audit firms reduce the potential of FSR but no evidence was derived from Local Top-10 audit firms. Nevertheless, the study also finds that the interaction of AQ, in either Big 4 or Local Top-10 audit firms did not weaken the impact of NAS on FSR. The results have aroused the thinking of companies and audit practitioners, where they need to limit their investment in NAS to remain AQ. This study's contribution is novel to demonstrate the importance of NAS and AQ in financial statement quality management among companies listed in China.

Keywords: Non-audit services; AQ; financial statement restatements; China; fee

Introduction

This study examines the effect of non-audit services (NAS) on financial statement restatement (FSR) among Chinese listed companies. In recent years, the number of restatements of financial statements of listed companies has increased, and the implicit problem of information quality of listed companies has attracted the attention of practical and academic circles (Stanley & DeZoort 2007). Concerns were raised that the provision of NAS mainly consultation and advisory services to the same audit clients is more likely to result in FSR. The provision of NAS may harm auditor independence and skepticism, and thus increase the likelihood of material misstatement that is required for restatement (Nik et al. 2022; Ahmed et al. 2022; Beardsley et al. 2021; Hohenfels & Quick 2020). Enron's accounting scandal revealed that the auditors received about USD27 million in non-audit fees, which was higher than the audit fees received from the statutory audit service, USD25 million. While the growth of NAS increases the audit firms' dependency on clients, has caused public, investors, and regulatory concerns about the quality of financial statements. After the Enron scandal, some countries in the world, such as Japan and the United States, banned the provision of NAS, which is different from China (Bloomfield & Shackman 2008). The development of non-audit services in China is gradually gaining strength, driven by national policies and market demand (Richard 2020). Additionally, the competition in China's audit service market is intensifying, leading to a decrease in audit fees and business opportunities over the years. In 2017, the Ministry of Finance, the China Securities Regulatory Commission, and the China Insurance Regulatory Commission issued a joint statement mandating that certified public accountants, particularly local firms, expand their services to include non-attest services such as consulting and advisory businesses. Chinese domestic audit firms must secure a foothold in the non-audit market to effectively compete with large foreign audit firms and sustain their presence in the audit market. Failure to do so could result in a significant loss of the non-audit market share, impeding the growth of Chinese audit firms.

Public concern about the possible link between the provision of NAS and the quality of financial statements because providing a range of services to management can lead to auditors becoming too close to management and losing their independence. Thus, auditors may not oppose management because they want to retain the additional revenue from NAS. In addition, a large number of empirical studies have examined the impact of NAS on audit quality (AQ), and also the impact of AQ and FSR, including Wahab et al. (2014), Bell et al. (2015), Velte (2022), and Zarefar et al. (2023). However, limited studies linked the impact of NAS on FSR. The existing evidence from various contexts is mixed to conclude the impact of NAS on a company's earnings and reporting quality (Bamahros & Wan 2015; Shi et al. 2021). Align with Ettredge et al. (2014) and Rajgopal et al. (2021)

that the FSR can also reflect a level of AQ, yet the limited empirical evidence motivates this study to examine the impact of the provision of NAS on the FSR among Chinese listed companies.

This study also argues that the provision of NAS results in FSR because the auditor cannot withstand independence (Rahmat et al. 2021). It raises concern whether the appointment of Big 4 and Local Top-10 audit firms can moderate the relationship between NAS and FSR. Aligned with agency theory, Big 4 audit firms (including PricewaterhouseCoopers, Ernst & Young, Deloitte & Touche, and KPMG) have more ability to withstand independence in confronting client pressure (Nik et al. 2022; Campa & Donnelly 2016). After the localization policy, the Big 4 have been renamed as PricewaterhouseCoopers Zhongtian, Ernst & Young Huaming, Deloitte & Touche Huayong, and KPMG Huazhen. To date, however, the literature is limited to prove the effect of high AQ mainly provided by Big 4 and Local Top-10 audit firms post the new policy can moderate the NAS and FSR relationship. Thus, it is crucial to examine the relationship between NAS and FSR after the localization policy[1] of international audit firms was implemented in China.

Data from China's A-share listed companies is used as the sample for analysis from 2010 to 2021, which is the data collected from the China Security Market and Accounting Research (CSMAR) database. This study found evidence that the provision of NAS is more likely to restate the financial statements, and thus, it is reasonable for the public to believe that the provision of NAS compromises auditor independence. This study also found Big 4 audit firms reduce the likelihood of companies restating their financial statements but no evidence was found from Local Top-10 audit firms. Finally, there is no evidence found the appointment of AQ from the Big 4 and Local Top-10 audit firms weakened the impact of NAS on FSR.

This study contributes to the literature by expanding research by Wahab et al. (2014), Bell et al. (2015), Velte (2022), and Zarefar et al. (2023) in several ways. First, this study analyses the relationship between NAS and FSR involving Chinese listed companies. Second, this study examines the association of AQ and FSR by using the Big 4 and Local Top-10 audit firms in China, and then, expands Campa and Donnelly's (2016) study by investigating the role of AQ as a mitigating factor for the relationship between NAS and FSR. Our findings contribute to regulators, standard setters, practitioners, and other industry players concerning the impact of providing audit and NAS, specifically for audit clients on reporting quality. They should have input about the AQ differential provided by Big 4 and Local Top-10 auditors. Although the Local Top-10 audit firms have a larger audit market among Chinese A-share companies than the Big 4, the evidence of the AQ may speak differently.

The remaining parts of this paper are organized as the following: Section 2 discusses the literature review and development of hypotheses. The research design is covered in Section 3, and the empirical findings are presented in Section 4. Section 5 covers the discussion and conclusion of the study.

Literature Review and Hypotheses Development

Agency theory explains agency conflict is based on the difference between owners and management (Jensen & Meckling 1976; Panda & Leepsa 2017). Since the purpose of the owner and the manager of the enterprise is completely different, and the information obtained by the two parties is not completely transparent, the owner of the enterprise pays the auditors to reduce agency conflict. The auditor is the best choice to provide a high level of assurance that all reported information is free from any material misstatements (Ciconte et al. 2022). The owners, shareholders, and prospective investors become more confident that the audited financial statements prepared by managers are true and objective. Nevertheless, if the auditor also provides NAS to the client, it may compromise the auditor's independence resulting in poor financial reporting quality and increasing the possibility of the company issuing FSR (Kinney et al. 2004; Campa & Donnelly 2016).

Providing NAS and audit services to the same client at the same time can effectively improve the efficiency of audit work because these two services can share resources and better knowledge about the client's business operation (Zaman et al. 2011; Svanström 2013; Carmona et al. 2015; Lai 2023). However, it may also lead to contradictions in the auditor's self-evaluation. Fees from the audit and NAS increase the auditor's economic dependence on clients, jeopardize the auditor's independence, thereby affecting AQ, and may even reduce the credibility and competency of auditors among the public (Tepalagul & Lin 2015; Meuwissen & Quick 2019).

Based on the agency theory, the negative impact of providing NAS can be mitigated by appointing good or high-quality auditors (Zaman et al. 2011). Auditors perform independent checks as an objective and rigorous third party, lending credibility to financial statements and accountability to the independent audit committee and shareholders (Ashbaugh 2004). If the auditor can withstand independence, it will help the auditor to play an effective supervisory role to reduce the information asymmetry between managers and shareholders. The Big 4 audit firms are widely considered to have a good audit reputation and can provide higher-quality audit services. In contrast, non-Big 4 audit firms have significant differences in terms of business level, audit resources, influence, and reputation (Tran & Tran 2023). Meanwhile, the AQ of the Local Top-10 is higher than that of the Local Non-Top-10 (Liu & Li 2022). In this case, however, localization of audit firms' policy in China may result in quality differential for audit and NAS.

NON-AUDIT SERVICE AND FINANCIAL STATEMENT RESTATEMENT

When an organization finds and fixes flaws in previously issued financial reports, it refers to the restatement of those financial reports. GAO's report is called "FSR", and other statements include "Restating Financial Statement" (Stanley & DeZoort 2007). Many factors may affect the restatement of financial statements. Beardsley et al. (2021) used FSR to measure AQ to study the impact of NAS on FSR, and Abdul et al. (2020) used FSR to measure accruals quality to study the impact of NAS on FSR (Beardsley et al. 2021; Abdul et al. 2020). However, the evidence is still limited to what extent outsourcing the NAS, mainly from the financial statement's auditor will affect the FSR, specifically after the localization policy in China.

NAS, relative to audit services, refers to a variety of professional services provided by accounting firms to clients other than auditing financial statements (Stanley & DeZoort 2007) such as account compilation, tax advisory and assessment, consultation, and other management advisory services. It was debated about the appropriateness of auditors to provide NAS to clients, mainly after the revelation of the Enron and Arthur Andersen accounting scandals. Solomon et al. (2005) believe that audit services and NAS can be provided at the same time, but the firm can separate them from the internal mechanism. Meanwhile, Kinney et al. (2004) emphasize that two unrelated organizations should be selected to manage the two professional services separately. This is not only about achieving the advantage of mutual promotion of information sharing, but the most crucial is to prevent NAS from intervening in delivering the audit service (Koh et al. 2013; Ratzinger-Sakel & Schönberger 2015). The companies must establish an internal monitoring mechanism to ensure that there is no conflict of interest between the two professional services.

The fierce competition in the audit market makes accounting firms have to break the situation to dominate the audit and accounting market for business survival, and thus, turn their development strategies to the NAS field (Ahmed et al. 2022; Beardsley et al. 2021). At the same time, the increase of uncertainty factors in the economic environment and the diversification of economic activities increase the demand for a variety of NAS. The diversified demand of the accounting market requires auditing firms to expand NAS based on audit services (Svanström 2013). Therefore, audit firms must adapt to the change in the economic environment, adjust their strategies, and provide NAS to seek audit firms' growth, improve marginal profits, and disperse business risks (Abass et al. 2022). In China, unless individual NAS may lead to a negative impact on the independence of the auditors, providing audit and NAS together should not be prohibited if conditions permit (Liang & Zeng 2005).

Many scholars come up with two viewpoints to categorize the effects of auditors performing NAS, either a beneficial view or a detrimental view **(**Nik et al. 2022; Campa et al. 2016**)**. The beneficial view proposes that serving NAS to audit clients can raise the quality of financial reports by giving auditors access to crucial data gathered throughout the audit process. To gain more NAS, auditors will be encouraged to boost their reputational capital investment **(**Campa et al. 2016**)**. When an auditing firm accepts a client's appointment for NAS, the auditor can have a more comprehensive understanding of the company's operating conditions. The auditor's understanding would reduce start-up costs required in the execution of audit procedures, improve audit work efficiency, and enhance AQ (Nam & Ronen 2012; Koh et al. 2013).

On the other hand, the detrimental view argues that the provision of NAS deepens the auditor's economic bond with the client, reduces the auditor's skepticism, increasing the auditor's incentive to undermine their independence and meet client pressure **(**Hohenfels & Quick 2020; Beardsley et al. 2021; Ahmed et al. 2022; Nik et al. 2022**)**. The audit firms may tend to depend on audit clients for survival, and the greater proportion of providing NAS further enhances the dependency. Moreover, the deepening of business cooperation and interaction between auditors and clients will establish a close relationship (Rahmat et al. 2021), and the auditors' independence could be compromised. Under the premise that AQ cannot be guaranteed, this study proposes the following hypothesis by arguing that the provision of NAS will lead to FSR:

H_1 The provision of NAS is positively associated with FSR.

AUDIT QUALITY (BIG 4 AND LOCAL TOP-10) AND FINANCIAL STATEMENT RESTATEMENT

Previous studies often define AQ as the auditor's competency to perform the audit assignment and the ability to report any material misstatement objectively (Rahmat & Ali 2016), which high-quality audit is often associated with the audit firm size. These large audit firms (Big 4 or Local Top-10) have more resources, expertise, and technology to provide high AQ. Thus, they are argued competent and more capable to withstand independence to provide preferable AQ (Rahmat & Iskandar 2004; Friedrich & Quick 2023). Even though the past evidence is mixed, the positive association between Big 4 audit firms and the quality of financial reporting is more dominant (Rahmat & Iskandar 2004; Gallery et al. 2008; Iskandar et al. 2010; Bennouri et al. 2015). Since the present evidence is limited, particularly in China, this study predicts that the appointment of the localized Big 4 audit firms may reduce the probability of Chinese companies issuing FSRs.

Additionally, this study also raises a concern about the other local top audit firms that have a substantially larger audit market in China than the Big 4 audit firms. These firms were renowned as Local Top-10 and predicted can provide high audit quality. Bianchi et al. (2023) claimed that the other six Local Top-10 audit firms are the closest competitors for the localized Big 4 in China. In general, Bianchi et al. (2023) found that the quality of Big 4 and other Local Top-10 improved by a similar extent from the pre- to post-localization rule period, resulting in statistically insignificant difference-in-differences estimates. Nevertheless, their actual impact was not widely explored as most previous researchers often categorize the firms as non-Big 4 or small audit firms (DeFond 1992; Citron & Manalis 2001; Fang et al. 2018). Thus, this study also predicts these Local Top-10 audit firms may be capable of enhancing the quality of financial statements and reducing the need for companies to restate their financial statements.

Aligned with the argument that auditors with highly reputable status derived from a renowned Big 4 and Local Top-10 audit firms may be more motivated to deliver high-quality audit services that result in improving the financial reporting quality, this study, in the case of FSR, develops the H_2 as below:

H_2 AQ either by Big 4 or Local Top-10 audit firms is associated with FSR.

MODERATING ROLE OF AUDIT QUALITY ON NON-AUDIT SERVICE AND FINANCIAL STATEMENT RESTATEMENT

Although there are two contradicting views concerning the impact of NAS, prominently offering NAS will undermine auditor independence and cause AQ to degrade quality (Nik et al. 2022; Ahmed et al. 2022). Nevertheless, Nik et al. (2022) and Campa et al. (2016) perceive that the negative impact of providing both audit and NAS on auditor independence can be minimized under the constraints of factors such as external environmental supervision, the legal system, or auditor reputation.

Zhang et al. (2020) used all Chinese A-share listed companies from 2011 to 2018 and found that AQ moderated the negative influence of the CFO's age and political background on FSR. Wang and Zhang (2005) analyzed companies with FSR in China to test the role of AQ. They found that companies with FSR are deliberately misstating prior years, and auditors are aware of this and reflect it in the audit opinion. Meanwhile, Guo et al. (2014) found that the most of companies that restated their financial statement due to a negative material misstatement received qualified audit opinions from the auditors.

Based on the above discussion, this study argues that the negative impact of NAS on AQ and the potential of companies restating their financial statement could be mitigated by appointing high AQ from Big 4 audit firms (Ettredge et al. 2014; Rajgopal et al. 2021). In the context of China, this study also argues that appointing the localized Big 4 and Local Top-10 audit firms can moderate the NAS and FSR relationship (Koh et al. 2013; Shi et al. 2021). Since the current evidence is scarce, mainly from the Local Top-10 audit firms, this study develops the H_3 as the following:

H_3 AQ by Big 4 or Local Top-10 audit firms moderates the relationship between the provision of NAS and FSR.

RESEARCH METHODOLOGY

DATA AND SAMPLE SELECTION

This study selects the data of China's A-share listed companies as a population for analysis, and the data for the period 2010 to 2021 was collected from the China Securities Market and Research (CSMAR) database. The initial population for the selected period is about 22,693 observations. This study performs a data screening process according to the following procedures:

1. Eliminated the listed companies whose trading status was ST and *ST[2] in the year;
2. Excludes companies from the financial institutional industry[3];
3. Exclude the observation samples with missing relevant data;

The total of companies with ST status and financial institutions that were excluded is about 1,947 observations. Meanwhile, there is about 7,070 observations were also excluded due to incomplete data as required for the regression models. The data screening process determines the final sample of this study, which consists of 13,676 company-year observations. The sample elimination process is summarized in Table 1.

TABLE 1. Sample elimination process

Selection process	Observations (n)
An initial sample of all A-share firms	22,693
Sample of financial firms and ST firms	1,947
Sample of missing data	7,070
Final sample	13,676

This study winsorizes data with continuous measures at the upper and lower up to 1% specifically to minimize a normality issue. As the dependent variable, FSR is measured as a dummy variable, the models were run by using the logistic regression. Additionally, this study conducts a few tests to confirm the robustness of the findings. First, we consider the impact of COVID-19 may influence the result, and thus, we perform regression by excluding the data from 2020-2021. This study also conducted hysteresis regression to explore the impact of the current period audit fees on the FSR in the next period.

REGRESSION MODEL

In order to verify the impact of NAS provision on FSR, as well as the moderating role of high AQ, this study constructs the following model for hypothesis testing:

$$FSR_{it} = \alpha_0 + \alpha_1 NAFEE_{it} + \alpha_2 INBFAQ_{it} + \alpha_3 NAFEE_{it} * INBFAQ_{it} + \alpha_4 SIZE_{it} + \alpha_5 LEV_{it} + \alpha_6 ROA_{it} + \alpha_7 GROWTH_{it} + \alpha_8 CSOWN_{it} + \alpha_9 BSIZE_{it} + \alpha_{10} \sum IND_{it} + \alpha_{11} \sum YEAR_{it} + \varepsilon_{it} \quad (1)$$

$$FSR_{it} = \alpha_0 + \alpha_1 NAFEE_{it} + \alpha_2 LBTAQ_{it} + \alpha_3 NAFEE_{it} * LBTAQ_{it} + \alpha_4 SIZE_{it} + \alpha_5 LEV_{it} + \alpha_6 ROA_{it} + \alpha_7 GROWTH_{it} + \alpha_8 CSOWN_{it} + \alpha_9 BSIZE_{it} + \alpha_{10} \sum IND_{it} + \alpha_{11} \sum YEAR_{it} + \varepsilon_{it} \quad (2)$$

Where FSR_{it} is the variable that describes FSR, coded as 1 if there is an issuance of FSR and 0 otherwise. $NAFEE_{it}$ is a variable used to measure NAS, calculated as the proportion of NAS fees to total audit fees. This study measures AQ using two proxies, i.e., Big 4 audit firms (*INBFAQ)* and Local Top-10 audit firms (*LBTAQ*) consistent with the objective to investigate the effect of AQ provided by top rank audit firms. The use of Big 4 is to be consistent with the classification used in past studies, and the Local Top-10 audit firms are consistent with China's audit market classification post the localization policy. This study does not compare the AQ provided by the localized Big 4 and the other six Top-10 audit firms. $INBFAQ_{it}$ is measured as a dummy variable, coded as 1 if the firm is audited by Big 4 and 0 otherwise. $LBTAQ_{it}$ is measured as a dummy variable, coded as 1 if the firm is audited by Local Top-10 and 0 otherwise.

This model also includes control variables that represent differential in companies' characteristics, i.e., *SIZE, LEV, ROA,* and *GROWTH*. *SIZE* is a firm size, calculated as a natural logarithm of the firm's total assets (Aier et al. 2005; Azzali & Mazza 2020; Aviantara 2023). *LEV* is a firm leverage, measured as the ratio of the firm's total debt to the firm's total assets (Hasnan et al. 2020). *ROA* is the return on assets that represents a firm's profitability, a ratio of the firm's profit after tax over total assets (Aviantara 2023). *GROWTH* is a firm's growth, measured based on the firm's revenue *t* - the firm's revenue *t-1*, divided by the firm's revenue *t-1* (Ettredge et al. 2010; Schmidt & Wilkins 2013; Sutrisno & Karmudiandri 2020).

Additionally, this model also includes variables that control differential in corporate governance characteristics, i.e., *CSOWN* and *BSIZE*. *CSOWN* is the largest or controlling shareholder's ownership, measured as a ratio of the largest shareholder's ownership (Wang & Wu 2011; Aziz et al. 2017; Hamedanlou et al. 2021). *BSIZE* represents a board size, measured based number of the board of directors' members (Hasnan et al. 2020; Oradi & Izadi 2020; Clatworthy & Peel 2021; Wijayati 2023). *Ind* is a dummy vector that represents the type of industry classification based on the Chinese stock exchange. *Year* is a dummy vector that represents the differential year of observations from 2010-2021. ε_{it} is the residual value.

EMPIRICAL RESULTS

DESCRIPTIVE AND CORRELATION ANALYSIS

Table 2 presents descriptive statistics for key variables. Table 2, Panel A shows the mean value of *NAFEE* was 0.25, indicating that NAS accounted for more than a quarter of the total audit fees, indicating NAS accounted for a relatively high proportion. The highest amount of non-audit fees paid by the company is 0.53, and this amount is considered very substantial. In addition, Table 2, Panel B shows the frequency of FSR is 4,240 which shows 31% of the observations had issued FSR. This statistic indicates that the proportion of FSR was relatively high.

TABLE 2. Descriptive analysis

Panel A						
Variables	n	Mean	Median	Std. Dev	Minimum	Maximum
NAFEE	13,676	0.25	0.25	0.09	0.03	0.53
SIZE	13,676	22.63	22.47	1.42	19.48	28.20
LEV	13,676	0.47	0.47	0.21	0.07	0.98
ROA	13,676	0.03	0.03	0.06	-0.29	0.19
GROWTH	13,676	0.41	0.13	1.17	-0.81	8.79
CSOWN	13,676	0.37	0.35	0.16	0.09	0.76
BSIZE	13,676	8.76	9.00	1.75	5.00	15.00
Panel B						
		Frequency	Percentage			
FSR	13,676	4,240	31%			
INBFAQ	13,676	1,368	10%			
LBTAQ	13,676	8,069	59%			

Note: Please refer to Table 3 for the identification and measurement of the variables.

Table 2, Panel B also shows that the frequency of *INBFAQ* is 1,368, which indicates that only 10% of the observations appoint the localized Big 4 audit firms during ten years. It was interesting, that the statistic is contradicted by statistics found in other countries, where the Big 4 normally dominate the audit market. Meanwhile, the frequency of *LBTAQ* is 8,069 which indicates 59%, of the observations appoint the other six Local Top-10 audit firms. The statistic shows that the six Local Top-10 is more prominent in China than the Big 4 audit firms, which is consistent with the audit market statistic reported by Bianchi et al. (2023). These statistics indicate that the majority of the Chinese listed companies favor appointing local-based top audit firms rather than international-based Big 4 audit firms.

TABLE 3. Correlation analysis

	FSR	*NAFEE*	*INBFAQ*	*LBTAQ*	*SIZE*	*LEV*	*ROA*	*GROWTH*	*CSOWN*	*BSIZE*
FSR	1									
NAFEE	0.05***	1								
INBFAQ	-0.07***	-0.17***	1							
LBTAQ	-0.06***	-0.19***	0.26***	1						
SIZE	-0.04***	-0.23***	0.34***	0.13***	1					
LEV	0.05***	0.01	0.07***	0.00	0.43***	1				
ROA	-0.07***	-0.10***	0.06***	0.09***	0.04***	-0.40***	1			
GROWTH	0.01	0.03***	-0.03***	-0.02*	-0.01	0.10***	-0.04***	1		
CSOWN	-0.05***	-0.07***	0.15***	0.12***	0.24***	0.03***	0.13***	-0.00	1	
BSIZE	-0.01	0.02*	0.07***	0.04***	0.25***	0.11***	-0.01	-0.04***	0.02***	1

Note: FSR is the financial statement restatement, coded as 1 if there is an issuance of FSR and 0 otherwise. NAFEE is a non-audit service, calculated as a natural logarithm of the NAS fees. INBFAQ is an AQ, measured as a dummy variable, coded as 1 if the firm is audited by Big 4 and 0 otherwise. LBTAQ is an AQ, measured as a dummy variable, coded as 1 if the firm is audited by Local Top-10 and 0 otherwise. SIZE is a firm size, calculated as a natural logarithm of the firm's total assets. LEV is a firm leverage, measured as the ratio of the firm's total debt to the firm's total assets. ROA is the return on assets, measured as a ratio of the firm's profit after tax over total assets. GROWTH is a firm's growth, measured based on the firm's revenue t - the firm's revenue t-1, divided by the firm's revenue t-1. CSOWN is the largest or controlling shareholders' ownership, measured as a ratio of the largest shareholder's ownership. BSIZE represents a board size, measured based number of the board of directors' members. IND is a dummy vector that represents the type of industry classification based on the Chinese stock exchange. YEAR is a dummy vector that represents the differential year of observations from 2010-2021. ε is the residual value.

Table 3 reports the Pearson correlation coefficient matrix. The correlation coefficient between *NAFEE* and FSR is 0.05 and has a significant positive correlation at the level of 1%, which preliminarily indicates that NAS increases the FSR. There are also significant correlations between *FSR* and other control variables, so it is necessary to further test the influence of NAS on FSR based on regression analysis. In addition, a significant negative correlation between *INBFAQ, LBTAQ,* and *FSR*, suggesting that higher AQ significantly reduces FSR. Nevertheless, the correlation coefficient between *INBFAQ, LBTAQ,* and *NAFEE* is also significantly negative, indicating that the NAS of the localized Big 4 and Local Top-10 audit firms are relatively low. Additionally, Table 3 also shows that the highest correlation is 0.43 between *SIZE* and *LEV*, and the second highest is 0.40 between *LEV* and *ROA*. Meanwhile, the other correlations among independent variables are lower than 0.40. These correlations indicate that all the independent variables in our model are free from any multicollinearity issues.

Multiple Regression Results

This study uses logistics analysis and GLS analysis respectively to empirically test the hypotheses. The results are shown in Table 4, with columns 1 and 2 for logistic analysis (Model 1a-Logit and Model 1b-Logit), and columns 3 and 4 for the GLS analysis (Model 2a-GLS and Model 2b-GLS). The result of Model 1a-Logit and Model 1b-Logit shows the odds ratio of *NAFEE* is 1.88 and 1.93, significant at a level $p < 0.10$ respectively. These results indicate that NAS is significantly associated with the Chinese company issuing the FSR. In columns 3 and 4, the result of Model 2a-GLS and Model 2b-GLS confirm the finding that showing NAS increases the likelihood of the Chinese company issuing the FSR, the coefficient (t-value) of *NAFEE* is 0.09 (2.01) and 0.15 (2.21), which is also significant at a level $p < 0.05$. The empirical results are robust enough to prove that the provision of NAS substantially is associated with the FSR. Thus, H_1 is supported.

TABLE 4. Analysis of NAS fees, AQ, and FSR

Variables	(Model 1a-Logit)	(Model 1b-Logit)	(Model 2a-GLS)	(Model 2b-GLS)
	β (odds ratio)	*β (odds ratio)*	*β (t-value)*	*β (t-value)*
NAFEE	0.49 (1.88)*	0.74 (1.93)*	0.09 (2.01)**	0.15 (2.21)**
INBFAQ	-0.59 (-3.01)***		-0.08 (-2.52)**	
*NAFEE*INBFAQ*	0.45 (0.55)		0.01 (0.10)	
LBTAQ		-0.07 (-0.53)		-0.01 (-0.19)
*NAFEE*LBTAQ*		-0.39 (-0.79)		-0.10 (-1.17)
SIZE	-0.05 (-2.66)***	-0.08 (-4.25)***	-0.01 (-2.76)***	-0.01 (-4.31)***
LEV	0.66 (5.11)***	0.70 (5.49)***	0.12 (5.13)***	0.13 (5.55)***
ROA	-1.41 (-3.77)***	-1.32 (-3.53)***	-0.26 (-3.97)***	-0.24 (-3.68)***
GROWTH	0.03 (1.82)*	0.03 (1.81)*	0.01 (1.81)*	0.01 (1.81)*
CSOWN	-0.65 (-4.55)***	-0.64 (-4.50)***	-0.11 (-4.54)***	-0.11 (-4.50)***
BSIZE	-0.00 (-0.03)	0.00 (0.20)	-0.00 (-0.04)	0.00 (0.14)
Constant	-0.72 (-1.14)	-0.18 (-0.28)	0.32 (3.06)***	0.41 (3.91)***
IND	Controlled	controlled	controlled	Controlled
YEAR	Controlled	controlled	controlled	Controlled
Observations	13,675	13,675	13,676	13,676
Pseudo R^2	0.169	0.168		
Wald chi^2			3,062.17***	3,046.06***

Note: Please refer to Table 3 for the identification and measurement of the variables. The dependent variable is FRS. z-statistics in parentheses, ****p < 0.01,* ***p < 0.05,* * *p < 0.1.*

Table 4 also shows that *INBFAQ* is negatively associated with *FRS*, the coefficient (odds ratio) and coefficient (t-value) are -0.59 (-3.01) and -0.08 (-2.52), significant at a level $p < 0.01$ and $p < 0.05$ respectively. These results are robust to show that good AQ provided by the Big 4 audit firms improves financial reporting quality by reducing the likelihood of the Chinese companies issuing FSR. Meanwhile, the results of *LBTAQ*, as shown in columns 2 (Model 1b-Logit) and 4 (Model 2b-GLS), show that Local Top-10 audit firms are not associated with *FRS*. These findings indicate that there is no evidence to prove that the Local Top-10 reduces the issuance of FSR among Chinese companies. Although the majority of Chinese listed companies favor appointing the Local Top-10 audit firms the ability of the Local Top-10 audit firms may be not comparable with the Big 4 audit firms. Table 4 also shows the results for the moderating impact of AQ on the NAS and FSR relationship. Column 1 adopts logistics analysis (Model 1a-Logit) and Column 3 adopts GLS analysis (Model 2a-GLS) for the interaction of *NAFEE*INBFAQ*. The coefficient of *NAFEE*INBFAQ* is not statistically significant in both models, indicating that the localized Big 4 does not moderate the NAS and FSR relationship. Meanwhile, Column 2 (Model 1b-logit) and Column 4 (Model 2b-GLS) show the results for *NAFEE*LBTAQ* and found that the odds ratio and the coefficient (t-value) of *NAFEE*LBTAQ* were not significantly related to FRS. These findings indicate that the Local Top-10 audit firms also did not moderate the impact of NAS on FSR.

ROBUSTNESS CHECKS

Avoid The Impact of Covid-19

Considering that enterprises' financing and operating capacity will be affected during the pandemic, auditors' audit activities will also be disrupted. Therefore, in order to eliminate the above problems, this study rerun the regression by excluding the samples from 2020 to 2021. The results are shown in Table 5.

TABLE 5. Excluding the impact of COVID-19

VARIABLES	(Model 1a-Logit)	(Model 1b-Logit)	(Model 2a-GLS)	(Model 2b-GLS)
	β (odds ratio)	***β (odds ratio)***	***β (t-value)***	***β (t-value)***
NAFEE	0.66 (2.28)**	0.72 (1.72)*	0.13 (2.23)**	0.15 (1.68)*
INBFAQ	-0.65 (-3.03)***		-0.11 (-2.77)***	
*NAFEE*INBFAQ*	0.58 (0.66)		0.08 (0.46)	
LBTAQ		-0.18 (-1.19)		-0.04 (-1.16)
*NAFEE*LBTAQ*		-0.05 (-0.09)		-0.01 (-0.13)
SIZE	-0.05 (-2.13)**	-0.07 (-3.60)***	-0.01 (-2.15)**	-0.02 (-3.57)***
LEV	0.63 (4.48)***	0.67 (4.83)***	0.13 (4.42)***	0.14 (4.80)***
ROA	-1.26 (-3.04)***	-1.19 (-2.89)***	-0.27 (-3.17)***	-0.26 (-3.00)***
GROWTH	0.04 (2.02)**	0.04 (2.04)**	0.01 (1.99)**	0.01 (2.03)**
CSOWN	-0.73 (-4.69)***	-0.72 (-4.62)***	-0.15 (-4.65)***	-0.14 (-4.57)***
BSIZE	-0.00 (-0.07)	0.00 (0.18)	-0.00 (-0.09)	0.00 (0.16)
Constant	-0.84 (-1.28)	-0.23 (-0.35)	0.32 (2.57)**	0.44 (3.55)***
IND	Controlled	controlled	controlled	controlled
YEAR	Controlled	controlled	controlled	controlled
Observations	9,760	9,760	9,761	9,761
Pseudo R^2	10%	9.91%		
Wald chi^2			1,453.75***	1,439.74***

Note: Please refer to Table 3 for the identification and measurement of the variables. The dependent variable is FRS. z-statistics in parentheses, ****p < 0.01, **p < 0.05, * p < 0.1*

The results show the association between NAS and FRS is consistent with the primary analysis. All models reported in Table 5 support the argument that the provision of NAS increases the probability of Chinese-listed companies issuing FSR. The odds ratio and t-value of the *NAFEE* are positively associated with FRS, significant in either a level of $p < 0.05$ or $p < 0.10$. The results also found consistency for the effect of *INBFAQ* and *LTBAQ* on *FSR,* where the Big 4 significantly reduced the Chinese listed company from issuing FSR, while no evidence was found for the *LTBAQ*. Additionally, the results are depicted in Table 5, Model 1a-logit and Model 2a-GLS also shows that the interaction variable, *NAFEE*INBFAQ* and *NAFEE*LTBAQ* are insignificantly associated with FSR. These findings are consistent with the primary analysis that suggests AQ, either from Big 4 or Local Top-10 audit firms, does not play moderating roles in the NAS and FSR relationship. This empirical evidence is robust to support the main findings after controlling the impact of the pandemic Covid-19 that possibly influences the relationship.

Lag Regression

Concern about the hysteresis of the impact of NAS on AQ, this study conducted hysteresis regression to determine the impact of non-audit fees in the current period on the FSR in the next period. The results are shown in Table 8.

TABLE 6. Lag regression

VARIABLES	(Model 1a-Logit)	(Model 1b-Logit)	(Model 2a-GLS)	(Model 2b-GLS)
	FSR_{it+1}	FSR_{it+1}	FSR_{it+1}	FSR_{it+1}
	β (odds ratio)	***β (odds ratio)***	***β (t-value)***	***β (t-value)***
NAFEE	0.54 (1.89)*	0.29 (0.70)	0.11 (1.88)*	0.06 (0.70)
INBFAQ	-0.65 (-3.21)***		-0.11 (-2.89)***	
*NAFEE*INBFAQ*	0.63 (0.73)		0.08 (0.47)	
LBTAQ		-0.33 (-2.28)**		-0.07 (-2.23)**
*NAFEE*LBTAQ*		0.38 (0.71)		0.07 (0.65)
SIZE	-0.05 (-2.44)**	-0.08 (-3.93)***	-0.01 (-2.50)**	-0.02 (-3.92)***
LEV	0.74 (5.49)***	0.79 (5.89)***	0.15 (5.47)***	0.16 (5.89)***
ROA	-0.99 (-2.58)***	-0.88 (-2.28)**	-0.22 (-2.73)***	-0.19 (-2.43)**
GROWTH	0.03 (1.42)	0.03 (1.37)	0.01 (1.38)	0.01 (1.37)
CSOWN	-0.62 (-4.11)***	-0.60 (-4.02)***	-0.12 (-4.07)***	-0.12 (-3.98)***
BSIZE	-0.01 (-0.39)	-0.00 (-0.14)	-0.00 (-0.37)	-0.00 (-0.15)
Constant	-1.54 (-1.35)	-0.82 (-0.72)	0.27 (1.69)*	0.41 (2.57)**
IND	controlled	controlled	controlled	controlled
YEAR	controlled	controlled	controlled	controlled
Observations	10,822	10,822	10,822	10,822
Pseudo R^2	9.18%	9.11%		
Wald chi^2			1,452.16***	1,446.87***

Note: Please refer to Table 3 for the identification and measurement of the variables. The dependent variable is FRS. z-statistics in parentheses, ***$p < 0.01$, **$p < 0.05$, * $p < 0.1$

The *NAFEE*INBFAQ* models (Model 1a-Logit and Model 2a-GLS) show that the coefficient (odds ratio) and coefficient (t-value) are 0.54 (1.89) and 0.11 (1.88) respectively, significant at level $p < 0.10$. These findings indicate weak evidence to prove that the current year's provision of NAS increases the potential of Chinese listed firms to issue FSR in the following year. The *NAFEE*LTBAQ* models (Model 1b-Logit and Model 2b-GLS) show that the *NAFEE* is insignificant which indicates no evidence to prove the provision of NAS increases of FSR issuance in the following year.

Nevertheless, all models show that *INBFAQ* and *LTBAQ* are negatively associated with the following year's FSR, significant at the level $p < 0.01$ *and* $p < 0.05$ respectively. Again, consistent with the primary analysis, this study found that the interaction variables, *NAFEE*INBFAQ* and *NAFEE*LBTAQ* are not significant in all models. It can be interpreted that there is no evidence to prove that AQ either Big 4 or Local Top-10 audit firms moderate the association between NAS and FSR. The absence of significant differences from the previous regression indicates that the results are robust.

Discussion and Conclusion

Based on the study of the NAS and FSR relationship, this study investigates the ability of AQ as a moderator variable to mitigate the impact of NAS on FSR. Since the provision of NAS may damage the auditors' independence, the U.S. Securities and Exchange Commission banned certain types of NAS in 2003, but in China, the income of audit firms from providing NAS has skyrocketed. In past studies, auditors' ability to maintain independence has been neglected. Therefore, while studying the relationship between NAS and FSR, this study added the moderating role of AQ measured by Big 4 audit firms and Local Top-10 audit firms in China to test whether the FSR can be mitigated while ensuring independence and AQ.

The findings show that the provision of NAS is positive and significantly correlated with the restatement of financial statements. Our study reinforces the conclusion of Bloomfield and Shackman (2008) that the larger the scale of providing NAS, the more likely lead to a decline in the quality of financial statements. Additionally, Big 4 audit firms negatively associated with FSR but no evidence was found from Local Top-10 audit firms. These findings indicate that localized Big 4 audit firms can reduce FSR after the localization policy. However, the inclusion of the other six Top-10 audit firms has weakened Local Top-10's ability to minimize FSR and expressed a significant difference in AQ remained among the localized Big 4 and the other six Top-10 audit firms. In addition, the moderating effect of AQ in either Big 4 or Local Top-10 audit firms has disappeared. Both Big 4 and Local Top-10 audit firms could not minimize the FSR while serving NAS to the audit clients. It can be interpreted that Big 4 or Local Top-10 audit firms that provide audit and NAS for the same clients may confront difficulty and become disabled to help companies reduce the issuance of FSR. Our findings are consistent with the detrimental view that argues the provision of NAS deepens the auditor's economic dependence, impairs the auditor's independence and skepticism, and increases the auditor's incentive to agree with the client's pressures (Hohenfels & Quick 2020; Beardsley et al. 2021; Ahmed et al. 2022; Nik et al. 2022).

These findings may lead to some thought in practice. First of all, our findings enrich the theory and knowledge about NAS and FSR in the context of the Chinese audit market after the audit firm localization policy. The research results can inspire regulators and standard setters. The insignificant findings for the Local Top-10 audit firms are supposed to raise concern to the regulators. Although the other six Top-10 audit firms dominate 59% of the audit market, the quality of the service may be lower than localized Big 4 audit firms. These results have aroused the thinking of companies and audit practitioners. If they want to improve the quality of financial statements, they need to limit the investment in NAS fees. Ensuring the quality of financial statements, thus, the regulators can restrict to a certain extent the provision of NAS by the Local Top-10 audit firms, specifically when involving the audited clients. Practitioners (accounting firms) have to ensure that they are capable of maintaining their independence before accepting any NAS appointment. The public and market participants can evaluate and determine their trust level towards auditors that provide NAS mainly to audited clients.

There are some limitations to the study. First, relying on the localized Big 4 and the Local Top-10 audit firms may limit our conclusions. The level of AQ may be related to the auditor's personal expertise. Our assumption is based on the high AQ provided by the Big 4 and Local Top-10 at the audit firms' level, ignoring the partner's individual factors. Secondly, the Big 4 are becoming more and more localized in China, but they do not play an effective moderating role when conflicting with the audit and NAS provision. Future research can refine the measurement of AQ, mainly to differentiate between the Big 4 and the other six Top-10 audit firms. Finally, our findings are limited to Chinese firms due to the localization policy, and future research may consider comparing similar issues in international settings.

NOTES

1. The Ministry of Finance, the State Administration for Industry and Commerce, the Ministry of Commerce, the State Administration of Foreign Exchange and the China Securities Regulatory Commission jointly issued the "Localization transformation Plan for Sino-Foreign Cooperative Audit firms", which was implemented on May 10, 2012, which means that the "Big 4" audit firms that entered the Chinese market in the past will transform into localized accounting firms. The "Transformation Plan" requires the "Big 4" cooperative firms to adopt the form of special general partnership after the expiration of the cooperation, with

more than 25 partners in line with the provisions of this plan, more than 100 Chinese certified public accountants, and the equivalent of RMB 10 million yuan. In addition, the "Plan" also stipulates other arrangements related to the transformation, including the continuation of the practice qualification after the "Big 4" cooperation adopts the special general partnership, the foreign exchange cancellation procedures of the original cooperative firm, the foreign exchange registration procedures of the newly established special general partnership firm, and the convergence of tax policies.

2. ST means that when a company has two consecutive years of losses or net assets below the face value of the stock, ST is added to the name of the stock, meaning special treatment; *ST means that the company has not improved in the third year and is still in a state of loss, which means that the company has the risk of delisting.

3. Excludes companies from the financial institutional industry, because there is a lot of money floating around in financial companies, but they themselves do not create actual wealth. If financial companies are counted, some things will be exaggerated, which is easy to cause misunderstanding.

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