

THE INFLUENCE OF BANK ON AUDITING PRACTICES AND AUDITOR'S OPINION

Tsing-Zai Wu, Accounting Administration, NCKU, Taiwan

Kazuhiko Kobori, Business Administration, NCKU, Taiwan

INTRODUCTION

The primary objective of this paper is to investigate the relation among the banks, companies, and accounting firms in Japan. Specifically, this study examines the effects of main bank on the earnings management and auditor's opinion. This study is motivated by little research having examined earnings management for the main banks' power in Japan. Generally, Japanese firms have had a strong relationship with banks. For example, companies make a deal with a few banks. Among these banks, the one bank is called main bank intimately.

The most important addition to be made to what Pong and Kita (2006) wrote that an accounting firm audited the bank, which has strong relationship companies. These companies were audited by the accounting firm which audited their main bank. Our research, one step forward, investigates whether these accounting firms are free-riding on main bank governance and express their fair opinion on the companies' financial statements.

The research is conducted about the system of Japanese organizations. Fang and Wang (2002) wrote that banks played an important role on system of unique governance. Pong and Kita (2006) showed that main banks had a power to prefer their auditor for cooperative companies in Japan. While Pong and Kita (2006) investigate the contract relationship among main bank, company, and accounting firm, our study simultaneously examines the effects of main bank on accounting practices and auditor's opinion by regression analysis. The empirical evidence on main banks' powers for accounting firms indicates a statistically significant correlation. The feature of this analysis is to examine the accounting and audit qualities in addition to discretionary accruals to accuse of main bank's intention in Japan.

As far as we know, empirical previous studies are not enforced including in bank, company, and accounting firm. Though an auditor monitors financial statements for stakeholders with Generally Accepted Auditing Standards (GAAS), main bank monitors companies' finance and managements. In citing Pong and Kita (2006), the intimate relations would be decreased monitoring cost between bank and accounting firm. Moreover, banks would have not a liking for expressing hostile audit opinions by accounting firms based on the Pong and Kita (2006) results. In this situation, how do

auditors keep independence in fact and in appearance about auditor's discharge? Moreover, is auditor able to intervene with long honeymoon between bank and company? To analyze the relationships in relation to earning manipulation, we grasp whether audit is a wreck by main bank power. To reveal the trait of unique monitoring system, we make a clear the power balance among bank, company, and accounting firm in Japan.

Douthett and Jung (2001) analyze the effect on earnings by Keiretsu. It showed that Keiretsu companies recognized small accrual compared to independent companies. Higher percentage of institutional stockholders controls managers' earning manipulation (Chung et al, 2004). Main banks put pressure auditor's expression.

This study examines whether main banks effect on auditors are related to earnings management by the firm. The motivation behind this study is the implicit assertion by that earning managements and rich corporate governance mechanism are positively related.

Theoretical background and Hypothesis

Main banks system is one of the governance systems in Japan. It has been taken in unique mechanism of business activities in other countries. Main banks system is considered as a source of power factors, since it has a major influence on both companies and accounting firms.

This section explains the main banks system, which is the best understood in the mechanism among main bank, companies, and accounting firms.

Bank and Companies

Companies have strong relationships with banks traditionally. Companies tend to collect funds with indirect funds, rather than issuing stocks. It is easy and comfortable for companies to raise funds from banks. Companies have the duty to disclose financial information for a number of investors and are monitored management by them. They have just only to requirements banks orders. However, management of companies depended on the banks to get the funds. Banks have had a strong effect on companies in Japan. Their relationships are unique. For example, they send personnel to get the management. It leads to the monitoring their funding companies. It is that the relationship between bank and company regulate the fraud by the company. Previous research (Shutou, 2010) regulates the managements' abnormal accrual by the holding bank.

There are two types bank in Japan. One is the city bank which is six mega banks. These banks has served as coordinator of their groups activities and raising funds as a facilitator of their group companies, For instance, Keiretsu and corporate group

mainly.

On the other side, the small and middle bank is in the part of the country. The small and middle bank has lent money and consulted management with companies' top managements closely.

The small and middle bank has more management relationship than city bank. Berger et al. (2005) smaller banks have stronger relationship with their borrowers. Ucida et al. (2008) also reported the same results about Japanese samples.

Hypothesis 1: Bank regulates the companies earning manipulations.

Hypothesis 2: Regional banks regulate the companies' earning manipulation, rather than city banks.

Companies and Accounting Firms

There is some research the relations between audit qualities and financial reporting. (Becker et al. 1998; Lobo and Zhou 2006; Ashbaugh-Skaife et al. 2008). Becker et al. (1998) showed that the client of Big 6 is less discretionary accruals than that of non-Big 6. Lobo and Zhou (2006) reported that audit qualities regulate the earning manipulations by management after SOX.

Hypothesis 3: Big accounting firm regulates earning manipulations than small and middle accounting firm.

Accounting Firms and Main Bank

Banks has played a monitoring role on companies' behaviors. The accounting firms are well aware of the monitoring role. The accounting firms audited the banks, which lend money for companies which have a tendency of being audited by the accounting firms (Pong and Kita, 2006). It is possibilities that banks power impresses on the accounting firms services. The accounting firms rely on the governance by main banks overly. They have potentialities of tendency to estimate high internal control. Audit risk might be estimated by the relationships among accounting firm, company, and bank. Roughly speaking, the accounting firm might be considered a free ride on the governance of main bank. Therefore, audit qualities could be lower by the main banks forces.

Hypothesis 4: Bank has much power on auditor's opinion.

Hypothesis 5: Audit qualities are lesser by on bank's governance.

Methodology

In testing the hypothesis, this study focuses on discretionary accruals and extraordinary items to observe the earning management of firms. The discretionary accruals are estimated as total accruals minus nondiscretionary accruals. Nondiscretionary accruals are calculated using cross-sectional CFO Jones model (Dechow et al., 1995). This analysis uses the cross-sectional accrual model to control

the effect of changing industry-wide economic conditions on total accruals and allows the coefficient to vary across years. By estimating the cross-sectional accruals model, each firm-year sample is assigned to an estimation portfolio that consists of similar firms matched on the basis of the industry classification code and the fiscal year.

The following is the model to estimate nondiscretionary accruals::

$$\frac{IB_t - CFO_t}{AT_{t-1}} = b_0 * \frac{1}{AT_{t-1}} + b_1 * \frac{(Sale_t - Sale_{t-1}) - (AR_t - AR_{t-1})}{AT_{t-1}} + b_2 * \frac{PPE_t}{AT_{t-1}} + e \quad (1)$$

IB_t : net income before extraordinary item in fiscal year t

CFO_t : net cash flow from operational activities in fiscal year t

AT_{t-1} : total assets at the end of year (t-1). State differently, the beginning total assets for year t.

$Sale_t$: sales in year t

AR_t : accounting receivable in year t

PPE_t : PPE at the end of year t

Data

The sample is selected at the 2010 using the following criteria:

1. The firms are listed on the Stock Exchange in Japan in 2010.
2. The fiscal year is the end of March.
3. Banks, Securities firms, insurance, and utilities firms are excluded.
4. Compliance with foreign accounting standards are deleted.

Financial data, Main bank, and Yuuka Shoken Houkokusho data necessary for the study is available from the eol database. Accountng firm data is from Hakyuso. The accounting data is based on consolidated financial statements.

References

- Bartov, Eli., Gul.Ferdinand ,A., Tsui, Judy, S.L., 2001. Discretionary-accruals models Choice: The case of Japan *International Journal of Auditing* 10: 87-98
- Chung, R., S. Ho, J. Kim. 2004. Ownership structure and the pricing of discretionary accruals in Japan. *Journal of international accounting auditing and taxation* 13(1):1-20.
- Dechow, P. M., R. G. Sloan, and A. P. Sweeney.1995. Detecting Earnings Management. *The Accounting Review* 70 (2):193-225.
- Douthett, E. B., K. Jung. 2001. Japanese corporate groupings (keiretsu) and the informativeness of earnings. *Journal of International Financial Management & Accounting* (12) (2): 133-159.
- Fan, J. P.H., and T.J Wong. 2002. Corporate ownership structure and the informativeness of accounting earnings in East Asia. *Journal of Accounting and Economics* 33 (3): 401-425.
- Pong, C. K. M., and Tsutomu Kita. 2006. Influence of banks on company auditor choice: The case of Japan. *International Journal of Auditing* 10 (2): 87-98.
- Shuto, A. (2006) Executive compensation and earning management: Empirical evidence from Japan. *Journal of International Accounting, Auditing and Taxation* 16 (1):1-26