

Maintaining Public Trust: Nonprofessional Inbestors' Trust Judgement Associated with Financial Reporting Restatements and Audit Tenure

Nicole R. McCoy, Ph.D.

Assistant Professor of Accounting
Deese College of Business and Economics,
North Carolina A&T State University

Aisha G. Meeks, Ph.D.

Professor of Accounting
Morehouse College, Division of Business and Economics

Robert Marley, Ph.D.

Associate Professor of Accounting
University of Tampa, Sykes College of Business

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Abstract

For over a decade, the accounting profession and regulators have recognized the importance of maintaining public trust in US financial markets. This study uses a bad news context to examine the source of financial reporting restatements and audit tenure on public trust. We predict and find a positive association between auditor-initiated restatements and the public's trust in both the management of the firm and the auditor. Surprisingly, it was observed that the public does not penalize management for implementing an independent auditor-proposed restatement despite the negative market reactions associated with financial restatements. The results indicate that efforts to promote transparency and reliability in financial reporting are important. The public's trust in the management of corporations and their auditors remains intact, regardless of how the restatements are initiated.

Keywords: Audit Judgment, Audit Quality, Audit Tenure, Restatement, Trust

Introduction

The annual financial statement audit, performed by an independent auditor, is one means of maintaining public trust in US financial markets. In light of a stream of audit failures, Congress established the Public Company Accounting Oversight Board (PCAOB) to oversee public company financial statement reporting practices in 2002. Since then, Congress and regulators have continued to extoll the need to maintain public trust in US financial markets. For example, James Kroeker, former Chief Accountant of the Securities and Exchange Commission (SEC), called for proposals to re-think the auditor-client relationship and recommended increasing the transparency of financial accounting principles and the disclosure notes as key to maintaining public trust (Kroeker, 2010). He also urged the audit profession to acknowledge that its ultimate clients are investors, noting that management accountants also play a critical role in providing transparent financial reporting (Kroeker, 2010). PCAOB has continued to stress the importance of transparency in financial reporting for high audit quality (PCAOB, 2016; Munter, 2023).

While public trust is not the catalyst underlying investors' decisions to buy or sell securities, it is necessary for investor participation in financial markets (Arrow, 1972; Rousseau et al., 1998). Consequently, audited financial statements are one means of improving investors' trust in the quantification of management's past decisions, which investors frequently use to assess management's veracity and firm-specific investment risk (Christensen et al., 2016).

A robust stream of archival research finds empirical evidence associating losses in public trust with negative financial market reactions (Guiso et al., 2008; Carlin et al., 2009; Sapienza & Zingales, 2012). Our study asks nonprofessional investors to make an investment decision after the company experiences a financial loss. A two (source of restatement: independent auditor initiated versus regulator initiated) by two (auditor tenure: short-term versus long-term) experiment was conducted, using nonprofessional investors as a proxy for the public. Based on Sheppard and Sherman's (1998) trust model, we find that when the independent auditor initiates a restatement, public trust in the company's management and the independent auditor remains high. Taking care to measure trust separately from investors' decisions to hold or sell their shares, we find empirical evidence suggesting that public trust can differ from investors' capital allocation decisions. Consequently, our findings suggest that negative financial market reactions may not necessarily indicate low levels of public

trust in management or the independent auditor; instead, they may be explained by other factors, such as investors' risk re-assessment. Our results also contribute to the investor judgment and decision-making literature by showing that even though investors may choose to divest their shares within a bad news context, they can continue to maintain trust in marketplace stakeholders.

In the next section, we discuss related prior studies and develop our research hypotheses, followed by our research methods and results. Our paper concludes by discussing our findings, limitations, and future research opportunities.

Background and literature review

Because purchasing equity is an act of faith, public trust is a necessary antecedent to investors' participation in financial markets (Arrow, 1972). Archival accounting studies find that public trust is positively associated with investors' participation in financial markets (Guiso et al., 2008; Carlin et al., 2009; Sapienza & Zingales, 2012; Christensen et al., 2016), developing from the implicit external relationships between management of publicly traded firms and their investors. The interaction between management and investors shapes investors' trust perceptions and, thus, their subsequent judgments. Sheppard and Sherman (1998) suggest that "risk is at the heart of how people do and should think about trust" and that risk is a determinant of the dependence and relational depth between the trustor (investors) and the trustee (management). The investor-management relationship represents deep dependence because many of management's actions cannot be easily reviewed by investors and because investors must rely heavily on management to achieve investors' desired outcomes. Investors' inability to monitor and review management's actions gives rise to risks associated with neglect. Trust, therefore, arises from interactions requiring transparency to foster investor perceptions of management's honesty, integrity, and concern (Sheppard & Sherman, 1998). The independent auditor is one of the investor's monitoring mechanisms in the investor-management relationship, ostensibly retained to protect the investor's interest by demonstrating competence, due care, and independence with regard to management's financial reporting.

Financial statements influence both management and investor actions and involve the independent auditor. Management, the independent auditor, or regulators like the SEC may initiate financial restatements. Financial restatements generate concern regarding management's and the independent auditor's competence and integrity (Almer et al., 2008; Chi & Sun, 2014). Although financial markets view restatements negatively (Owers et al., 2002), Palmrose, Richardson, and Scholz (2004) find that restatement source

affects the market reaction. Restatements initiated by the auditor are associated with negative market reactions (Palmrose et al., 2004), which they assume affect public trust since a restatement indicates that previously released financial statement reports should be relied upon with heightened skepticism (Almer et al., 2008). However, although some investors will choose to sell their securities after a restatement, causing a negative market reaction, this negative reaction may not necessarily indicate that investors have lost all trust in management or the independent auditor. More specifically, Sheppard and Sherman's (1998) trust model suggests investors' trust in management and the independent auditor should be higher when the independent auditor initiates the restatement than when a regulator initiates the restatement because auditor- or management-initiated restatements should signal honesty and integrity to investors. We predict the following:

H1_A: Independent auditor-initiated restatements retain higher levels of public trust in management than regulator-initiated restatements.

H1_B: Independent auditor-initiated restatements will retain higher levels of public trust in the independent auditor than regulator-initiated restatements.

The Effect of Audit Tenure on Public Trust in a Negative News Context

A stream of literature finds auditor tenure to be negatively associated with investor satisfaction (Geiger & Raghunandan, 2002; Sainty et al., 2002; Carcello & Nagy, 2004; Dao et al., 2008) such that as auditor tenure increases, more investors vote against ratifying the incumbent auditor (Sainty et al., 2002; Dao et al., 2008). Somewhat paradoxically, Ghosh and Moon (2005) find that investor perceptions of earnings quality are positively associated with tenure.

Sheppard and Sherman's (1998) trust model would suggest that short auditor tenures may increase auditor independence since the external auditor is new and, therefore, needs to be more knowledgeable about operations and, thus, more ready to question company management. Furthermore, as investors become increasingly dissatisfied with the auditor (as proxied by their votes against ratifying the incumbent independent auditor), investors must rely more heavily on the financial statement assertions made by management. Thus, we predict public trust in management will increase with audit tenure and public trust in the independent auditor will decrease with audit tenure:

H2_A: Long audit tenure will yield higher public trust in the company's management than short audit tenure.

H2_B: Long audit tenure will yield lower public trust in the external auditor than short audit tenure.

Research method

Our experimental instrument consisted of three distinct sections: demographics, task materials, and debriefing questions. Participants were required to assess the likelihood of continuing to hold the investment (HOLD), trust in company management (MGT TRUST), and trust in the company's independent auditor (AUD TRUST).¹ Each participant was informed that he/she earned an annual salary of \$50,000, had an investment portfolio of \$35,000, and that \$3,500 of his/her portfolio was invested in the target company.

Company Demographics

The target company was an airplane manufacturer with large government contracts that was neither the lowest nor highest performing investment in the participant's investment portfolio (Sharma, 2006). Further, the target company maintained ratios and operating metrics consistent with the industry average.

Methodology

The experiment was administered online using Amazon's Mechanical Turk platform. The M-Turk participants who completed the experiment received \$1 for an average of 6 minutes of their time, which is the equivalent of \$10 per hour. Consistent with other studies using M-Turk participants (Paolacci et al., 2010; Rennekamp, 2012; Farkas & Murthy, 2014; Buchheit et al., 2018; Brink et al., 2019), we pre-screened the participants by establishing qualifications for participation. To participate in our study, the M-Turk participant must have resided in the United States, be 18 years or older, and have a worker rating of 95 percent and above.

Independent Variables

Participants were randomly assigned to one of two conditions for the restatement treatment: an auditor-initiated restatement or an SEC ("regulator") initiated restatement. The restatement announcement was designed from an actual news release of an international publicly traded clothing company. The restatement states that the company, at the 'direction of its external auditors (Securities and Exchange Commission), has re-evaluated its lease accounting practices.' To ensure the manipulation was salient, participants were asked who initiated the restatement of leases.

¹ In our study, participants were asked about the likelihood of continuing to hold this investment in their portfolio. Given a 7-point Likert scale, the overall sample mean was 3.39; therefore, the general public would unlikely retain this investment within their portfolio.

For the auditor tenure treatment, participants were randomly assigned to one of two conditions: auditor tenure of three years or audit tenure of 15 years. Audit tenure of three years was classified as a short audit, and an audit tenure of 15 years was classified as a long audit tenure, consistent with Sainty, Taylor, and Williams (2002) and Dao, Mishra, and Raghunandan (2008). To ensure participants perceived audit tenure manipulation in the desired manner, participants were asked about the duration of the auditor's tenure with the firm.

Participants and Related Demographics

Our participants were paid Amazon Mechanical Turk workers residing in the United States. On average, each participant was single, without children, between 35 and 39 years old, and possessed an associate degree with no accounting-related experience. Our sample was approximately 57 percent male participants, 40 percent purchased shares in at least one publicly traded company, and 88 percent self-reported having little to no investment experience.

Results

This study includes two manipulation check questions: one for financial restatement and one for auditor tenure. Out of 224 completed observations, seventy participants (31.25 percent) did not correctly answer both manipulation check questions based on their treatment groups, and these observations were eliminated from our analysis.

Manipulation and Comprehensive Checks

Our experiment included two comprehensive check questions to ensure that participants were actively engaged in the task and had a basic understanding of capital markets. The first comprehensive check question asked participants if the case restatement resulted in a negative or positive adjustment of net income. The second comprehensive check question asked participants whom the SEC regulates. Fifteen (15) out of the remaining 154 observations (6.70 percent) did not answer both comprehensive check questions correctly. The final sample consisted of 139 out of 224 completed observations (62.05 percent) and 56 observations of the final sample (40.29 percent) purchased publicly traded company shares. Panel A of Table 1 presents these descriptive statistics tabularly.

Table 1 - Descriptive Statistics for Sample and Related Judgments

<i>Number of observations (percentage) for each group within the sample</i>						
	No	Investing	Investing Exp		Overall Sample	
	Exp					
Original number of participants	137	(100.00)	87	(100.00)	224	(100.00)
Less: Failed Manipulation Checks	42	(30.66)	28	(32.18)	70	(31.25)
Subtotal	95	(69.34)	59	(67.82)	154	(68.75)
Less: Failed Comprehensive Checks	12	(8.79)	3	(3.45)	15	(6.70)
Final Observations	83	(60.58)	56	(64.37)	139	(62.05)

Univariate Analysis – Investing Experience

Forty percent of our final sample disclosed experience with buying and selling stock. Libby et al. (2002) find that individuals with a basic understanding of investing are suitable proxies for nonprofessional investors. As investing experience increases, unfiltered information and financial disclosures have a greater impact on investor judgment (Elliott et al., 2008; Krische, 2019). In addition, nonprofessional investors with investor experience will have less trust in the financial markets (Kersting et al., 2015). Therefore, we performed within treatment group comparisons of no experience and experienced nonprofessionals to understand the impact that investing experience may have on our results.

Consistent with Libby et al. (2002), our participants who had investing experience (INVESTING EXP) and participants with little to no investing experience (No INVESTING EXP) perceptions were consistent with the overall sample as it pertains to both dependent variables: management trust (MGT TRUST) and independent auditor trust (AUD TRUST).² Thus, all participants were included in the overall sample and analyses.

Multivariate Analyses

We use an analysis of variance model to evaluate the effects of restatement source (RESTATE) and auditor tenure (TENURE) on the public's trust in company management (MGT TRUST) and its independent

² Participants in the auditor-initiated restatement condition trusted company management (mean = 3.32) more than the participants in the SEC-initiated restatement condition (mean = 2.90, $t = 0.080$, $p > 0.10$). Participants in the short auditor tenure condition trusted the company's management (mean = 3.09) less than participants in the long auditor tenure condition (mean = 3.21, $t = -0.544$, $p > 0.10$). Participants in the auditor-initiated restatement condition trust of the external auditor (mean = 5.00) trusted the company's independent auditor more than the participants in the SEC-initiated restatement condition (mean = 3.87, $t = 4.232$, $p < 0.01$). Participants in the short auditor tenure group (mean = 4.57) trusted the company's independent auditor more than participants in the long auditor tenure condition (mean = 4.40, $t = -0.592$, $p > 0.100$).

auditor (AUD TRUST). Tables 2 and 3 present detailed statistics regarding these hypothesis tests. We find a significant main effect for the initiation source of financial restatement on trust in company management ($F_{1, 135} = 4.081, p < 0.05$) and trust in the independent auditor ($F_{1, 135} = 16.337, p < 0.001$). The restatement source trust such that when the independent auditor initiates a financial restatement, the public's trust in management and the independent auditor is greater than when a regulator initiates a financial restatement. Even though the “bad news” conveyed by a financial restatement affects investor’s capital allocation decisions (i.e., their decisions to hold or sell their securities), public trust remains relatively high in management and the independent auditor when the auditor initiates a restatement, possibly due to the perceived transparency associated with an auditor-initiated restatement. These results support H1_A and H1_B. However, we did not find empirical evidence that auditor tenure significantly influenced trust. Thus, our results do not provide support for H2_A and H2_B.

Robustness Analysis

We consider the robustness of our results by evaluating the confounding effects of other marketplace stakeholders on the public’s trust in the company’s management. The marketplace consists (non-exhaustively) of the stockbrokers, traders, and the company’s management. We find that investors’ trust in firm management correlates with their trust in the capital markets (SM TRUST), their trust in stock market professionals (SMP TRUST), and the relationship between the firm’s management and independent auditors (MGTEA RELATE). Panel C of Table 2 presents detailed results in tabular form. Further, we find that stock market professionals ($F_{1, 132} = 3.488, p < 0.10$) and the firm’s management-independent auditor relationship to marginally influence ($F_{1, 132} = 3.398, p < 0.10$) trust in the source of restatement initiation, suggesting firm management affects public trust in financial markets irrespective of investors’ general perceptions of financial markets.

We also examine the confounding effects of the public’s trust in the independent auditor (Bailey & Sawyer, 2012). Public trust in the independent auditor may be influenced by the public’s trust in the public accounting industry (PA TRUST) and perceptions of auditor independence. Three debriefing questions were explicitly asked of participants to examine contextual factors: How independent was the external auditor from the company (EA INDEPEND), to what extent do you believe the external auditor is unbiased (EA UNBIAS), and to what extent does the external auditor have a responsibility to verify the company’s financial statements (EA RESPONS). Panel C of Table 3 details participants' responses and our robustness analysis. We find the public’s trust in the external auditor to be

firmly associated with perceptions of trust in the public accounting industry ($F_{1, 131} = 3.999, p < 0.05$) and the auditor's responsibility to verify the financial statements ($F_{1, 131} = 29.525, p < 0.10$).

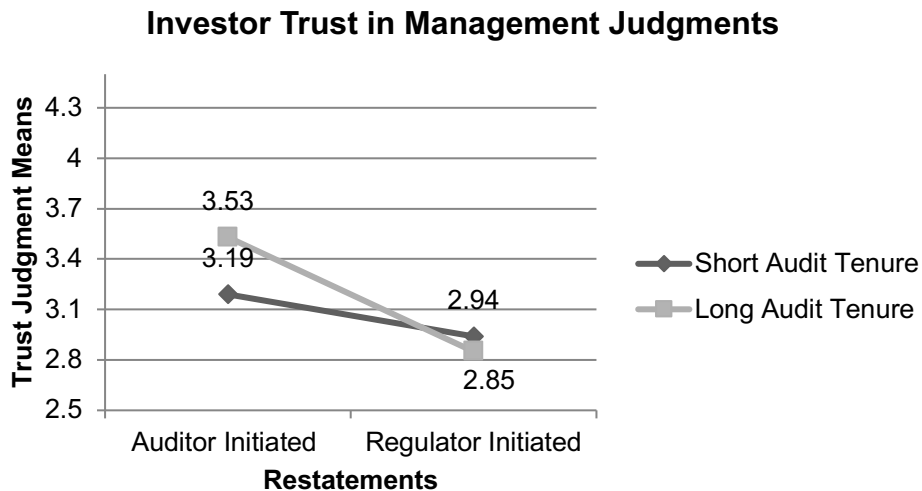
Table 2 – Analysis of Variance and Covariates for Public Trust in Management

Public Trust Judgments in Management					
Panel A: Mean (number) of Public Trust Judgment in Management					
<i>Restatements</i>					
<i>Audit Tenure</i>	Auditor Initiated		Regulator Initiated		Row Mean
Short	3.19 (48)		2.94 (34)		3.09 (82)
Long	3.53 (30)		2.85 (27)		3.21 (57)
Column Mean	3.32 (78)		2.90 (61)		3.14 (139)
Panel B: Conventional analysis of variance of Public Trust Judgment in Management					
Source	Sum of Squares	df	Mean Square	F	Sig
Restatement	7.137	1	7.137	4.081	0.045**
Tenure	0.546	1	0.546	0.312	0.577
Restatement X Tenure	1.570	1	1.570	0.898	0.345
Error	236.069	135	1.749		
Panel C: Analysis of covariance of Public Trust Judgment in Management					
Source	Sum of Squares	df	Mean Square	F	Sig
Restatement	6.518	1	6.518	3.968	0.048**
Tenure	0.069	1	0.069	0.042	0.838
SM TRUST	0.011	1	0.011	0.007	0.934
SMP TRUST	5.730	1	5.730	3.488	0.064*
MGTEA RELATE	5.582	1	5.582	3.398	0.068*
Restatement X Tenure	2.392	1	2.392	1.456	0.230
Error	216.842	132	1.643		
In a two (restatement: auditor initiated vs. regulator initiated) by two (audit tenure: short vs. long) between-subjects experiment, investors are asked to assess how much trust they had in the company's management after a restatement announcement. Investors' trust in the company's management may be highly correlated with their trust in the capital markets (SM TRUST), trust in stock market professionals (SMP TRUST), and the relationship between the company's management and external auditors (MGTEA RELATE). *, **, ***, and **** Indicate $p < 0.10$, $p < 0.05$, $p < 0.01$, and $p < 0.001$ respectively.					

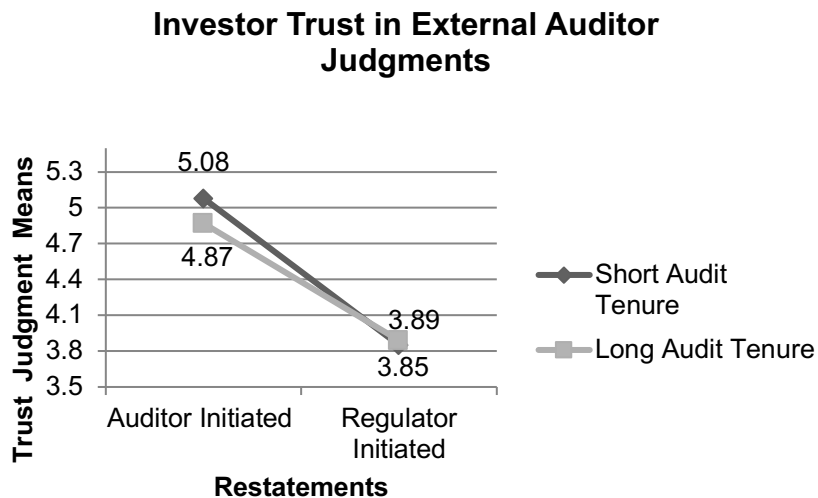
Table 3 – Analysis of Variance and Covariates for Public Trust in the External Auditor

Public Trust Judgments in the External Auditor					
Panel A: Mean (number) for Public Trust Judgment in the External Auditors					
<i>Restatements</i>					
<i>Audit Tenure</i>	Auditor Initiated		Regulator Initiated		Row Mean
Short	5.08 (48)		3.85 (34)		4.57 (82)
Long	4.87 (30)		3.89 (27)		3.87 (57)
Column Mean	4.57 (78)		4.40 (61)		4.50 (139)
Panel B: Conventional analysis of variance of Public Trust Judgment in the External Auditor					
Source	Sum Squares	of <i>df</i>	Mean Square	<i>F</i>	<i>Sig*</i>
Restatement	40.426	1	40.426	16.337	0.000***
Tenure	0.271	1	0.271	0.109	0.741
Restatement X Tenure	0.529	1	0.529	0.214	0.645
Error	334.065	135	2.475		
Panel C: Analysis of covariance for Auditor Trust Judgments					
Source	Sum Squares	of <i>df</i>	Mean Square	<i>F</i>	<i>Sig*</i>
Restatement	5.550	1	5.550	3.243	0.074*
Tenure	0.882	1	0.882	0.517	0.474
PA TRUST	6.844	1	6.844	3.999	0.048**
EA INDEPEND	0.998	1	0.998	0.548	0.446
EA UNBIAS	50.526	1	50.526	29.525	0.000***
EA RESPONS	5.736	1	5.736	3.352	0.069
Restatement X Tenure	0.001	1	0.001	0.000	0.983
Error	224.181	131	1.711		
In a two (restatement: auditor initiated vs. regulator initiated) by two (audit tenure: short vs. long) between-subjects experiment, investors are asked to assess their trust in the company's management after a restatement announcement. Investor's trust in an auditor may be highly correlated with the investor's trust in the public accounting industry (PA TRUST) and their perception of auditor independence. Auditor independence may be include the investor's perceptions regarding (1) how independent was the external auditor (EA INDEPEND), (2) to what extent you believe the external auditor is unbiased (EA UNBIAS), and (3) what extent the external auditor has responsibility to produce the company's financial statements. *, **, ***, and **** Indicate $p < 0.10$, $p < 0.05$, $p < 0.01$, and $p < 0.001$ respectively.					

Figure 1 – Graphs of the Investors’ Judgments of Management and Auditor Trust
Panel A – This figure shows the management trust judgment means for restatements (auditor initiated/ regulator initiated) and audit tenure (short/long).



Panel B – This figure shows the auditor trust judgment means for restatements (auditor initiated/regulator initiated) and audit tenure (short/long).



Conclusion

Public trust is a necessary pre-condition for investor participation in financial markets. Additionally, US regulators have a legislative mandate to maintain public trust in American financial markets. Examining how restatement source and auditor tenure affect public trust, we find that although investors tended to sell their shares regardless of the restatement initiation source, as predicted, public trust in the firm management and the

independent auditor is more significant when the auditor initiates an financial restatement compared to when a regulator initiates the restatement. We found some evidence that auditor tenure may not influence public trust in management and the independent auditor, even though prior research finds auditor tenure to be positively correlated to investor dissatisfaction (Sainty et al., 2002; Dao et al., 2008).

This paper contributes to the stream of literature that examines the antecedents of public trust in financial markets. Our findings provide empirical behavioral evidence that auditors contribute to trust in US financial markets, suggesting that management of public companies can retain higher levels of public trust by implementing auditor-initiated financial restatements compared to contexts where a regulator initiates financial restatement. These results suggest that auditors should not be timid in proposing financial restatements and that management should be more receptive to auditor-initiated restatements.

Our findings are subject to several limitations. First, this study does not address the magnitude of the loss of public trust associated with financial restatements. Although public trust is better maintained when an auditor initiates a financial restatement, investors generally decide to sell their shares, which we assume is a rational response to this bad news context for mitigating portfolio risk. Future research could extend our work by obtaining measures of participants' trust in the external auditor and management before administering manipulations to examine the magnitude of the loss in public trust associated with financial restatements. In addition, future research could advance theoretical explanations regarding why investors still chose to sell their shares even though they reported higher levels of trust in management when the auditor initiated a financial restatement.

In summary, our results suggest that regardless of decades of accounting scandals and debacles, there are actions that management, the public accounting profession, and regulators can take to mitigate the loss of public trust in bad news contexts. The fight for public trust has been worthwhile, and research may be an avenue available for maintaining and restoring public trust in financial markets.

Conflict of Interest: The authors declare no conflict of interest.

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Data Availability: The data are available upon request from the corresponding author.

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