

Audit Partner Disciplinary Actions and Financial Restatements

ABSTRACT

This study investigates the signaling role and rectification effectiveness of auditor disciplinary systems. The signaling role refers to whether the sanction reflects poor audit quality of the disciplined auditor and rectification effectiveness refers to whether the disciplinary actions enhance subsequent audit quality. In this study, we utilize financial restatements to surrogate audit failure. Empirical results indicate that the likelihood of restating financial statements of the clients of disciplined auditors is significantly higher than that of clients of non-disciplined auditors. The more serious the type of sanction and the more enforcement actions on the record of the disciplined auditor, the higher the likelihood of restating financial statements audited by the disciplined auditor. This implies that auditor disciplinary actions are an effective indicator of audit quality.

We examine the rectification effectiveness of disciplinary actions from two perspectives. One deals with the punishment effect on the disciplined auditors; and the other deals with the deterrent effect on non-disciplined auditors, specifically the successor auditors. Empirical results on the punishment effect indicate that the probability of financial statements audited by the disciplined auditors being restated significantly decreases after sanctions. In addition, after sanctions, the likelihood of restating financial statements audited by a disciplined auditor is not significantly different from that of restating financial statements audited by a non-disciplined auditor. Regarding the deterrent effect, our results indicate that when a company replaces its sanctioned audit partner, the likelihood of subsequent restating financial statements audited by the successor audit partner is reduced. Based on the results from the punishment effect and the deterrent effect together, we conclude that auditor sanction rectifies audit quality. In sum, audit partner disciplinary actions can signal audit quality and are effective in enhancing audit quality.

Keywords: *Auditor sanction, Disciplinary actions, Financial restatements, Auditor change*

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