

# **The Influence of External Auditors, Capital Markets, and Main Banks on Earnings Manipulations: Evidence from Japan**

**Kazuhiko Kobori**

**National Kaohsiung First University of Science and Technology**

**Robert Hutchinson**

**Michigan Technological University**

*The present study investigates the influence of main industrial banks, capital markets, and international audit firms on earnings manipulations in Japan using a sample of firms listed on Japanese stock exchanges. A modified Jones model is used to measure earnings management using discretionary accruals as proxy, and the findings suggest that the main industrial banks continue to play a primary role in Japan's system of corporate governance. However, global capital markets and international accounting standards may be slowly eroding this influence. This may have significant implications for international investors and policy makers as Japan continues through a protracted economic recession.*

## **INTRODUCTION**

The Japanese business model is unique and has been described as “Criss-Crossed Capitalism” in the popular business press (Economist, 2008). At the center of this model are the main industrial banks, which play a primary role in Japan's system of corporate governance. Previous research has attempted to describe this relationship between the “Main Bank” and cooperative firms in terms of the scope of this relationship. Douthett and Jung (2001:137) contend that the Main Bank has historically played an important monitoring role within the group. In particular, within the “Keiretsu” (Japanese for “web”) System, the Main Bank has functioned both as a creditor and shareholder and therefore had strong incentives to become informed about the affiliated firms and their investment opportunities. It used this information to ensure that efficient choices were made. Fan and Wong (2002:16) reported that, unlike other East Asian firms that were typically family-controlled, Japanese firms were institutionally owned, with principal control held by the Main Banks within industrial groups. Japanese ownership structures also differed from their East Asian peers in the degree of control exercised by the Main Banks. However, Weinstein and Yafeh (1998) questioned the long-term viability of the Japanese system in free markets, as the Main Bank made use of its monopoly power to lend capital at significantly higher than market interest rates.

These previous studies mentioned above all provide evidence of the unique economic bond that exists between Japanese firms and their Main Banks. Postwar Japan has seen the dominance of a relatively strong relationship between Japanese firms and their affiliated industrial banks and a correspondingly weak relationship with financial markets (Aoki et al., 1994). For nearly five decades, the Main Bank's role as the principal source of working funds, monitor of management behavior, and savior in times of

financial crisis has largely gone uncontested. However, the combination of a protracted recession beginning in the early 1990s, which continues to this day, and the adoption of International Financial Reporting Standards (IFRS) has brought the existing system into question.

Firms are now obliged to report holding stocks at fair market value and recognize the mounting losses of mutual holding stocks caused by the recession. Many firms dumped these stocks onto the market to avoid further losses on the income statement. Much of these losses were written off to bad debts, thus restructuring the composition of group firms, and diluting the Main Bank's power over the member firms within the Keiretsu (Numata and Takeda, 2010).

While the arguments against the continued viability of the Keiretsu System in Japan abound in the academic literature and have been supported by anecdotal accounts in the popular business press, few studies have empirically examined this decline in relation to growth in influence of international financial markets and international accounting firms. This paper attempts to address this gap in the literature by examining earning manipulations and the influence of banks, stock markets, and accounting firms using a 2010 sample from Japanese stock exchanges.

This paper makes several contributions to the literature, building on the foundation of previous studies. Pong and Kita (2006) found that accounting firms selected to audit companies often had strong existing relationships with the Main Banks. They identified that Main Banks had a clear preference to use the same accounting firm to audit their affiliated companies within the Keiretsu. However, this study only investigated the structural mechanisms among Main Banks, accounting firms, and cooperative firms through ratio analysis.

The current study makes two significant contributions to the aforementioned work of Pong and Kita. First, it uses a more recent sample of firms, after a decade in which there was a great deal of change in the population through mergers and acquisitions between cooperative firms and banks in financial trouble. Also, the dissolution of ChuoAoyama, an auditing firm affiliated with the global network of PricewaterhouseCoopers, had also occurred in this time period (Numata and Takeda, 2010). In light of these influential events, there is a clear need to follow up on their study and quantify the effects of these changes in the subsequent decade.

Numata and Takeda (2010) contend that the traditional role of the Main Bank has decreased, and the role of auditors increased since the early 2000's. In particular, the Main Banks' monitoring powers have weakened with regards to large listed firms, as they have increasingly turned to international financial markets to raise capital rather than through their Keiretsu affiliation.

The second major contribution the current paper is that it investigates the influence of Main Banks, financial markets, and accounting firms on accounting practices through regression analysis. In short, this study examines the influence of external factors on earning manipulations. Towards this end, this study examines the accounting and audit qualities, in addition to discretionary accruals, to better understand the scope of external influences within this uniquely Japanese context. The current study hopes to significantly increase our understanding of the increasing influence international financial markets and the international reputation of the audit firm on management accounting practices, and the corresponding decreasing influence of Main Banks.

## **THEORETICAL BACKGROUND AND HYPOTHESES DEVELOPMENT**

### **Keiretsu Financing: Pressure to Change**

The uniquely Japanese system of ownership and financing, the Keiretsu System, began to show signs of weakness under the pressure of a collapse in the real-estate market and the ensuing decade-long recession of the 1990's (Numata and Takdea, 2010:181). The dependence of firms on their affiliated Main Bank for financing and monitoring was further reduced by a decrease in the traditional cross-shareholding between the banks and cooperative firms and a substantial wave of mergers and acquisitions beginning in the late 1990's (Scher, 1997). Stable shareholding and cross-shareholding decreased 18 percent and 11 percent between 1991 and 2003 respectively (Patrick, 2004).

Large firms could no longer depend on a never-ending supply of cash from Main Banks under these stagnant economic conditions, and instead had had to look increasingly towards international financial markets. Raising capital from the financial markets has meant an increasing scrutiny of shareholder value and placed more importance on the assertions of the auditor's report. Based on the data from the Bank of Japan, banks have continuously reduced lending funds since 1989. Conversely, the volume of the repayments on bank loans has been in excess of new borrowing since 1996. Sakai and Shikano (2011) pointed out that the increasing of equity financing reduced the dependence on bank loans, made easier by the policy effects of financial liberalization, deregulation of market securities and high stock prices.

Large firms, eager to attract new capital from investors, have adapted with the establishment of investor relations departments and the issuance of annual reports and prospectuses. Additionally, new markets have emerged for high-growth and emerging stocks in Japan, such as Mothers, Jasdq, Centrex, Q-Board, and Ambitious. Initial public offerings (IPOs) have numbered 1,100 since 2000, with the vast majority occurring in emerging stock markets. Small and medium-sized enterprises (SMEs), in particular, have found raising capital easier, with the requirements to list on emerging stock markets being less onerous.

However, Yonezawa (2006:142) has brought up two important issues with regards to the emerging stock markets. One, in an aim to increase the number of listed firms on emerging markets, emerging markets may not always strictly enforce listing standards. Second, there is the risk of increasing numbers of managers without awareness of the social responsibilities of public firms, corporate governance, and regulatory compliance. Such managers might neglect, whether knowingly or inadvertently, to maintain the disclosures after the firm has listed. In fact, several notable incidences of fraud have already occurred on emerging markets. For example, Livedoor Co., Ltd., listed on Mothers, became infamous for its creative accounting in 2006. Examples like this may have contributed to the recent decrease of IPOs in Japan, from 106 firms in 2007 to only nine firms in 2009.

It is evident that the growth of direct financing through financial markets has weakened the relationship between banks and cooperative firms. At the same time, growth in emerging markets may contribute to greater earnings manipulations, leading to the following hypothesis:

*Hypothesis 1: Emerging stock markets are closely associated with an increased level of earnings manipulations by firms.*

### **City vs. Regional Banks**

The Keiretsu System has had a major influence on both firms and the Accounting Industry in Japan (Pong and Kita, 2006). There are two types of bank in Japan: "City Banks" and regional banks. First and foremost in influence are the City Banks, which consist of the six mega-banks associated with the Keiretsu System in Japan. These banks are: Tokyo Mitsubishi UFJ, Mitsui Sumitomo, Mizuho, Mizuho Corporate, Risona, and Saitama Risona. These banks coordinate the activities of their corporate groups (Keiretsu) and facilitate the raising of funds. The regional banks are the small and medium-sized banks in close proximity to the firms.

Previous research on the Main Bank system in Japan has focused on solving the agency problem of perverse managerial behavior caused by information asymmetry between the City Banks and large firms (Aoki et al., 1994; Hoshi et al., 1994; Teranishi, 1993). However, there has been less empirical research focused on the relationship between the regional banks and firms.

Relationship lending research from the United States can provide much needed insight in this arena. Berger and Udell (2002) describe two bases for lending United States: one is transaction lending based on hard information, i.e. financial statements, and the other is relationship lending based on soft information, i.e. personal knowledge. Muramoto (2005) indicated that relationship lending is particularly important in the Main Bank system in Japan and is continually reinforced over time. In comparison with their counterparts in the United States, SMEs and their Main Banks in Japan are associated three times as long, with an average relationship of 30 years (Kano, 2006). In this light, banks in Japan have a vast cache of soft information on their borrowers.

Stein (2002) discussed the priority of relationship lending among small and mid-sized banks. Large banks are often at a disadvantage in case of the relationship lending, where the time required to evaluate soft information may be cost prohibitive. Small and mid-sized banks depended much on their personal relationships with the existing borrowers to mitigate the information asymmetries and agency costs (Boot, 2000; Berger and Udell, 2002). Fama (1985) argued that access to soft information is useful not only in screening and making risk assessments, but also for monitoring loan performance in the future. Diamond (1984) wrote that the soft information of an insider position allowed a bank to effectively mitigate the inherent risk of information asymmetry.

Berger and others (2005) showed that smaller banks had stronger relationship with their borrowers. Uchida and others (2008) supported this finding using the same methodology in Japan. They reported that evidence from recent academic research suggests that small banks may have a distinct advantage over large banks in providing credit to SMEs.

Therefore, small and mid-sized banks have a profound influence on the corporate governance practices within the borrowing firms. They utilize soft information to reduce asymmetry and to strengthen monitoring practices. In addition, close geographic proximity makes it easier to monitor management behavior and serves as a deterrent to fraud. Quite interestingly, Brevoort and Hannan (2003) find that the change in information technology that could give rise to increasing functional distances between lenders and borrowers appear to have been adopted only by a small groups of banks. Based on this, the following hypothesis is proposed:

*Hypothesis 2: Affiliation with small and mid-sized Regional Banks is associated with a lower level of earnings manipulations.*

### **Big vs. Regional Accounting Firms**

The “Big” accounting firms in Japan, along with their international partners – Shin Nihon LLC (Ernst & Young LLC), Tohmatsu LLC (Deloitte Touche Tohmatsu LLC), and Azusa LLC (KPMG Azusa LLC), have a strong motivation to detect and report material misstatements for fear of compromising their valuable international reputations and affiliations. Several studies have tackled the relationship of auditor reputation and earning manipulations in the literature. For example, Becker and others (1998) have found that non-“Big Six” auditors’ clients reported discretionary accruals greater than the discretionary accruals reported by Big six auditors’ clients. Subsequent studies have supported these findings with similar results (Francis et al., 1999; Nelson et al., 2002; Lobo and Zhou, 2006; Ashbaugh-Skaife et al., 2008).

There is some research that big accounting firms have a tendency to avoid audit contracts with risky firms. DeAngelo (1981) found evidence that Big 5 auditors avoided the litigation risk, compared with non-big 5 auditors. Francis (1999) and Becker and others (1998) found that the large international audit firms seemed to resist managers’ accounting manipulations, consistent with the result of DeAngelo (1981). Reynolds and Francis (2001) noted that larger clients also posed greater litigation risks, and that Big 5 auditors reported more conservatively for larger clients – suggesting that preserving their international reputation motivates auditor behavior. Shu (2002) described big accounting firms resigning from audit contracts with firms with increased litigation risks and emerging mismatches. Martinis and others (2011) found that country and client type significantly influences an auditor’s client risk assessment and planned total hours.

In summary, big accounting firms have a tendency to avoid audit contracts of risky firms in order to maintain their sterling reputations among existing clients. Therefore, it is hypothesized that association with the “Big” accounting firms deters firms from excessive earnings management.

*Hypothesis 3: Affiliation with a “Big” accounting firm is associated with lower levels of earning manipulations.*

## **Audit Report and Earning Manipulation**

Some studies in the literature have focused on the connection between accounting accruals and the presence of modified audit opinions (Francis and Krishnan, 1999; Bartov et al., 2000; Bradshaw et al., 2001). There is clear evidence that earnings manipulations increase the likelihood of receiving a modified audit opinion (Bulter et al., 2004).

Managers may feel pressure to manipulate earnings in order to avoid a going concern opinion on audit reports. Rosner (2003) found the relationship between modified audit opinions and abnormal accruals was largely limited to firms having had going concern opinions. Their sample firms had negative accruals that were likely due to severe financial distress. In other words, these firms had already performed the earnings manipulations in the previous year and earnings were turned over in the sample year. Therefore, their results were not consistent with previous studies that found firms receiving modified opinions as a result of earnings management. Francis and Krishnan (2010) found that auditors of high-accrual firms were more likely to issue modified opinions for asset realization uncertainties than for going concern problems.

Research in Japan has focused on increasing earning manipulations in the face of looming bankruptcy (Suda et al., 2007; Takada, 2007); however, few studies have examined auditors' reports and balance sheet with subsequent events. This study considers the subsequent events as an important disclosure for shareholders. Auditors should disclose these kinds of events on the auditor's report and should note these events for investors in order to mitigate earnings manipulations.

Therefore, it is hypothesized that the additional information of auditors' reports is associated with decreased earning manipulations:

*Hypothesis 4: Additional information (subsequent events) on auditor's report is associated with decreased levels of accruals.*

## **Non-Audit Fees and Earning Manipulation**

Previous academic research, which examines the effect of non-audit fees on earning manipulations, has failed to produce a unified understanding. On one hand, research has found an association between such fees and earning manipulations. Gore and others (2001) found that non-Big 5 auditors allowed more earning manipulation than Big 5 auditors in a sample of U.K firms. They also provided evidence of positive associations between the provision of non-audit services and earnings manipulation. Frankel and others (2002) investigated the association between the provision of non-audit services and earnings quality. Their findings showed that firms purchasing more non-audit services from their auditor were more likely to report larger absolute discretionary accruals. That is to say, the purchasing of non-audit services was associated with lower quality earnings, i.e. non-audit fees had a negative effect on earnings quality. Srinidhi and Gul (2007) demonstrated that non-audit fees had an impact on the auditor's independence.

The other mass of research suggests that non-audit service fees are not linked, or at best weakly linked, with earning manipulations. Prior studies have addressed these regulatory concerns and examined whether non-audit service fees adversely impact the quality of reported earnings numbers as measured by the level of abnormal accrual adjustments (Frankel et al., 2002; DeFond et al., 2002; Ashbaugh et al., 2003; Chung and Kallapur, 2003; Reynolds et al., 2004). With the notable exception of Frankel and others (2002), these studies have produced limited evidence that the provision of non-audit service fees was associated with the reported earnings quality. And, Asbaugh and others (2003) would directly challenge these findings, suggesting that non-audit fees did not have an effect on the independence of auditors and were not related to earnings manipulations. Chung and Kallapur (2003) found that audit fee metrics were not associated with the absolute value of discretionary accruals. Ruddock and others (2006) explored the concerning between the provision of non-audit services by incumbent auditors and the extent to which earnings reflected bad news on a timely basis. Their findings revealed that higher levels of non-audit services were not associated with reduced conservatism.

In summary, the results of previous research have failed to produce a unified understanding. However, this study hypothesizes that both audit fees and non-audit fees have a positive effect on the level of accruals.

*Hypothesis 5: Audit and non-audit fees are positively associated with the level of accounting accruals.*

## SAMPLE AND METHODOLOGY

The sample for this study was selected using the following criteria:

1. The firms are listed on Japanese stock exchanges in 2010.
2. The year end is March.
3. Banks, securities firms, insurance, and utilities firms are excluded.
4. Firms complying with foreign accounting standards are excluded.

The financial data, Main Bank information, and securities reports necessary for the current study were obtained through the eol database. The accounting data is found on the consolidated financial statements. The breakdown of the final sample by category and descriptive statistics are presented in Tables 1 and 2 below.

**TABLE 1**  
**SAMPLE STATISTICS**

Category	Number
City Bank and Big Accounting Firm	1,132
City Bank and Regional Accounting Firm	469
Regional Bank and Big Accounting Firm	244
Regional Bank and Regional Accounting Firm	86
Total	<u>1,931</u>

In testing the aforementioned hypotheses, the current study focuses on total accruals and discretionary accruals in order to observe the level of earning manipulations of firms. The discretionary accruals are estimated as total accruals minus nondiscretionary accruals. Non-discretionary accruals are calculated using the modified CFO Jones model (Kasznik 1999). Suda and Shuto (2004) indicated this model had the highest interpretabilities in the earning manipulation models. 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:

$$(IB_{it} - CFO_{it}) / AT_{it-1} = \alpha_1 (1/AT_{it-1}) + \alpha_2 \{ (SALE_{it} - SALE_{it-1}) - (AR_{it} - AR_{it-1}) / AT_{it-1} \} + \alpha_3 (PPE_{it} / AT_{it-1}) + e_{it} \quad (1)$$

where:

- IB = net income before extraordinary items: defined as net income, minus gains from extraordinary items, plus loss from extraordinary items;  
 CFO = net cash flow from operational activities;  
 AT = total assets;

SALE = sales;  
 AR = account receivables;  
 PPE = gross property, plant, and equipment and  
 e = error term.

**TABLE 2**  
**DESCRIPTIVE STATISTICS**

Variables	N	Mean	Std. dev.	Minimum	Maximum
IB <sup>a</sup>	1,931	3438.480	15514.100	-58013.000	297744.000
CFO	1,931	13688.680	50517.470	-76942.000	1177226.000
ATt-1	1,931	180765.280	531045.710	397.000	10239540.000
Sale	1,931	166221.900	452400.920	105.000	7517277.000
Salet-1	1,931	188022.540	520127.050	153.000	8436974.000
AR	1,931	30371.760	76733.180	0.000	948200.000
ARt-1	1,931	28695.570	73522.750	0.000	1082569.000
PPE	1,931	66677.960	266043.410	0.000	5878266.000
Total accruals <sup>b</sup>	1,931	-0.049	0.058	-0.551	0.360
Non-discretionary accruals <sup>c</sup>	1,931	-0.032	0.066	-0.466	0.493
Discretionary accruals <sup>d</sup>	1,931	-0.018	0.048	-0.493	0.366

a IB is net income before extraordinary item defines as net income, minus gain from extraordinary item, plus loss from extraordinary item  
 b Total accruals are the difference between IB and CFO, deflated by lagged total assets.  
 c Non-discretionary accruals are estimated for each firm-year as the expected value of accruals based on Eq.(1).  
 d Discretionary accruals are total accruals minus Non-discretionary accruals.

## RESULTS

This study wishes to identify which, if any, external factors affect the total number of accruals and discretionary accruals. The total accruals and discretionary accruals are estimated using multiple regression analysis for all sample firms (N=1,931).

Table 3 shows the results of the multiple regressions with total accruals in Panel A and discretionary accruals in Panel B. It presents the results the effect of the Main Bank, the stock market, and accounting firms on earning manipulations of the firms by using of total accruals and discretionary accruals as dependent variables.

The model is as follows:

$$Accrual_{it} = \beta_1 CPA_{it} + \beta_2 AF_{it} + \beta_3 NAF_{it} + \beta_4 MB_{it} + \beta_5 STOCK_{it} + \beta_6 UNQUALIFIED_{it} + \beta_7 GOING_{it} + \beta_8 SUBSEQUENT_{it} + e_{it} \quad (2)$$

where:

Accrual = total accrual;  
 CPA = 1 if auditor is a non-big accounting firm, 0 otherwise;  
 AF = logarithm of audit fees;  
 NAF = logarithm of non-audit fees;  
 MB = 1 if Main Bank is small-and medium-sized bank, 0 otherwise;  
 STOCK = 1 if stock market is for emerging markets, 0 otherwise;  
 UNQUALIFIED = 1 if additional information is on unqualified opinion, 0 otherwise;  
 GOING = 1 if going concern information is on opinion, 0 otherwise;

SUBSEQUENT = 1 if subsequent event information is on opinion, 0 otherwise; and  
 e = error term.

**TABLE 3**  
**MULTIPLE REGRESSION MODEL**

Variables	Coefficient	t-Statistic	Prob.
Panel A: Absolute Value of Total Accruals			
C	0.071	19.970	- **
CPA	(0.008)	(3.270)	0.001 **
MB	-	(0.130)	0.894
STOCK	(0.006)	(2.180)	0.030 *
UNQUALIFIED	(0.008)	(2.550)	0.011 *
SUBSEQUENT	0.011	2.420	0.016 *
GOING	(0.001)	(0.130)	0.898
AF	-	0.890	0.372
NAF	-	0.080	0.935
Adjusted <i>R</i> -square	0.009		
N	1,931		
Panel B: Absolute Value of Discretionary Accruals			
C	0.026	7.960	- **
CPA	(0.003)	(1.260)	0.207
MB	0.001	0.250	0.800
STOCK	0.007	2.910	0.004 **
UNQUALIFIED	(0.010)	(3.440)	0.001 **
SUBSEQUENT	0.011	2.690	0.007 **
GOING	0.021	2.760	0.006 **
AF	-	(0.020)	0.987
NAF	-	0.300	0.763
Adjusted <i>R</i> -square	0.009		
N	1,931		

Note: p-values are one tailed; \*\*, \*, # denote  $p < 0.01$ ,  $< 0.05$ ,  $< 0.10$

The results demonstrate that the Main Bank is not a strong predictor of total accruals ( $t = -0.130$ ,  $p = .894$ ). On the other hand, stock markets are negative linked with total accruals ( $t = -2.180$ ,  $p = .030$ ), suggesting the significance of stock markets' effect on total accruals. These results are consistent with the arguments presented earlier about the declining influence of Main Banks and the increasing influence of emerging markets, supporting the first and second hypotheses.

The variable of CPA is negatively associated with total accruals ( $t = -3.270$ ,  $p = .001$ ). This suggests that big accounting firms are not associated with decreased levels of total accruals. While the results do not support the third hypothesis, they are consistent with the results of previous academic research (Francis et al., 1999; Nelson et al., 2002; Lobo and Zhou, 2006; Ashbaugh-Skaife et al., 2008).



The model also presents evidence suggesting that the accounting firms' presentation and timing of audit reports is significantly associated with the level of accruals. An unqualified audit opinion with explanatory information is negatively associated ( $t = -2.550$ ,  $p = .011$ ) and subsequent reporting is positively associated with total accruals ( $t = 2.420$ ,  $p = .016$ ). These results support the fourth hypothesis.

Finally, neither audit nor non-audit fees are found to be associated with total accruals ( $t = .890$ ,  $p = .372$ ;  $t = .080$ ,  $p = .935$ , respectively). These findings show that fees are not associated with earning manipulations and do not support the fifth hypothesis.

Thus, accounting firms, stock markets, and a clean audit opinion with additional information are negatively associated with total accruals. The size of the accounting firm does not significantly affect the level of earning manipulations. The model is as follows:

$$\begin{aligned} \text{Dis Accrual}_{it} = & \theta_1 \text{CPA}_{it} + \theta_2 \text{AF}_{it} + \theta_3 \text{NAF}_{it} + \theta_4 \text{MB}_{it} + \theta_5 \text{STOCK}_{it} + \theta_6 \text{UNQUALIFIED}_{it} \\ & + \theta_7 \text{GOING}_{it} + \theta_8 \text{SUBSEQUENT}_{it} + e_{it} \end{aligned} \quad (3)$$

where:

Dis Accrual	=	discretionary accrual;
CPA	=	1 if auditor is a non-big CPA firm, 0 otherwise;
AF	=	logarithm of audit fees;
NAF	=	logarithm of non-audit fees;
MB	=	1 if Main Bank is small-and medium-sized bank, 0 otherwise;
STOCK	=	1 if stock market is for emerging markets, 0 otherwise;
UNQUALIFIED	=	1 if additional information is on unqualified opinion, 0 otherwise;
GOING	=	1 if going concern information is on opinion, 0 otherwise;
SUBSEQUENT	=	1 if subsequent event information is on opinion, 0 otherwise; and
e	=	error term.

Panel B of Table 3 illustrates the effects of the external factors on discretionary accruals. The results are consistent with the previous results on the overall level of accruals. The Main Bank does not significantly affect the level of discretionary accruals ( $t = .250$ ,  $p = .800$ ). On the other hand, the effect of the stock market is significantly positively correlated ( $t = 2.910$ ,  $p = .004$ ). The listed firms on emerging markets are significantly associated with the dependent variable. These results suggest that the choice of stock market may provide an important signal of earning manipulations. Many rapidly growing SMEs are listing on emerging stock markets, with less stringent listing requirements, to raise funds. For example, information technology (IT) firms often cannot report stable earnings given the rapidly changing market conditions and may be more inclined towards earnings manipulations and listing on emerging markets. The results support the first hypothesis. The variable of CPA is not significantly associated with discretionary accruals ( $t = -1.260$ ,  $p = .207$ ). These results suggest that discretionary accrual has nothing to do with size of accounting firms; therefore, the second hypothesis is rejected.

With regards to the audit report itself, a clean opinion with additional information is negatively associated with discretionary accruals ( $t = -3.440$ ,  $p = .001$ ). Further, there are close correlations between the reporting of subsequent events and going concern information and discretionary accruals ( $t = 2.690$ ,  $p = .007$ ;  $t = 2.760$ ,  $p = .006$ , respectively). These results suggest that reporting itself has a significant effect on earning manipulations. Moreover, it presents interesting evidence that going concern information is strongly associated with discretionary accruals.

Additionally, No significant correlation is found between audit fees and non-audit fees and discretionary accruals ( $t = -0.020$ ,  $p = .987$ ;  $t = 0.300$ ,  $p = .763$ , respectively). The fifth hypothesis is rejected.

## CONCLUSION AND DISCUSSION

The current study analyzes the relationships among banks, stock markets, and accounting firms and earnings manipulations. Our most interesting findings show that banks do not significantly impact earning manipulations on the part of Japanese firms. This means that Main Banks may not play an important role in deterring earning manipulations and may play a significantly reduced role in corporate governance in Japan. However, results also suggest higher levels of discretionary accruals are associated with emerging markets. This may have significant implications for the future of corporate governance in Japan and require further study.

Unqualified audit opinions are associated with lower levels of earning manipulations. This suggests that listed firms recognize the importance of auditing as a signal for information quality. The importance of audit reports with regards to raising capital on financial markets should continue to grow along with the weakening influence of the Main Banks.

Although the results have significant implications for practice, as with any study, there are limitations. The data are the main limitation, as a single year sample was collected. The second limitation is the applicability of results outside of Japan. The results of this study might not be applicable to other countries, due to the unique nature of Japanese corporate governance. However, our findings provide useful information for international investors on the financial markets in Japan. Future research may want to extend the methodology to other markets, particularly other East Asian markets. In conclusion, this study provides strong evidence supporting the declining influence of Main Banks in Japan. At the same time, it suggests the growth in influence from capital markets and accounting firms. These results have significant implications for policy makers in Japan as issues of corporate governance arise. It also presents significant opportunities for researchers to expand our understanding of the uniquely Japanese model of corporate governance.

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