

Distinguish the Investment Value of Listed Companies Through Financial Statements

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Abstract

At present, the frequent financial whitewashing of A-share listed companies seriously misleads investors' judgment of the intrinsic value of the enterprise, thus affecting the final investment decision-making, exacerbating the information asymmetry and overall investment risk in the capital market. Based on this, this article systematically sorts out the relevant domestic and foreign literature in the fields of financial statement whitewashing, fraud identification and enterprise investment value evaluation, further integrates the existing research framework, and explores the areas that have not been fully paid attention to in the current academic research through multi-angle comments. The research adopts the narrative literature review method to summarize, compare and comprehensively analyze relevant theories and relevant literature at home and abroad around the three themes of "whitewashing motivation and means", "identification methods and tools" and "value distortion and consequences". The study found that the existing research has made rich achievements in the classification of whitewashing means and the development of identification models, but there are three widespread structural limitations: first, insufficient consideration of industry specificity; second, lack of practical solutions for small and medium-sized investors; and third, the research on new whitewashing techniques derived from new accounting standards is obviously sluggish. This article integrates the two key areas of financial fraud and enterprise valuation at the theoretical level, and provides clear literature support and direction guidance for investors to optimize the screening logic and improve the early warning mechanism for the regulatory level at the practical level.

Keywords

financial statements whitewash, listed company, investment value, fraud identification, enterprise valuation

1. Introduction

The basic function of the capital market is to guide the flow of resources to efficient subjects through price signals, and the realization of this function depends on the authenticity and reliability of the financial information disclosed by listed companies. The premise of value investment theory is that investors judge the intrinsic value of the enterprise based on the basic information of the enterprise, especially the financial statements, including but not limited to the balance sheet and profit statement of the enterprise and the cash

flow statement, and then make investment decisions. However, when financial information is deliberately distorted, this logical chain is destroyed.

The financial fraud problem in China's A-share market has been around for a long time. According to the statistics of Liu et al. [1], since the discovery of the first financial fraud case in 1996, the number of companies involved has been growing rapidly, and the number of companies involved in financial fraud has exceeded 400 every year since 2019, accounting for more than 10% of the total number of listed companies in the same year [1]. Landmark cases such as Kangmei Pharmaceutical's false increase of monetary funds by 29.9 billion yuan and Kangdexin's false increase in total profits of 11.5 billion yuan not only refreshed the market's understanding of the scale of fraud, but also aroused widespread public questions about the reliability of capital market information [1]. At the regulatory level, the 2019 Securities Law was revised to aggravate the punishment for false statements, the 2020 Amendment to the Criminal Law (11) extended the sentence for the crime of illegal disclosure, and the new regulations of the Supreme People's Court in 2022 canceled the pre-litigation procedure for false statements [1]. However, a stricter system still seems to find it difficult to fundamentally curb the spread of financial whitewashing.

From the theoretical level, existing research has made progress in many dimensions. In terms of fraud motives, the fraud triangle theory provides a classic framework for understanding the motives of fraud [2, 3]; in terms of identification methods, from the Jones model to Beneish M-score, to emerging technologies based on machine learning, the methodological system is increasingly rich [4]; in the analysis of consequences A large number of empirical studies have confirmed the stock price collapse and long-term revenue loss after the exposure of financial fraud [1, 4]. However, the above research belongs to a relatively independent academic field. Fraud research focuses on the behavior of the “falter” itself and the logic behind it, the identification research focuses on the technical tools of “detective”, and the valuation research focuses on the wealth effect of the “victim”. The systematic relationship between the three has not been fully established.

More importantly, there are three structural gaps in the existing literature. First, most identification models are constructed based on industry-wide samples, and less consideration is given to the impact of industry-specific asset structure and revenue recognition methods on whitewashing means and identification indicators. Second, the existing identification tools are mainly aimed at professional audit institutions and regulatory entities, and the practicability is obviously insufficient for small and medium-sized investors with limited information acquisition ability. Third, the implementation of the new accounting standards in line with the international standards in 2006 and the new income and new leasing standards since 2017 has provided new flexibility for the whitewashing of statements, but the academic community's research on the new whitewashing methods generated by the change of standards and its impact on valuation is obviously lagging behind.

Based on the above analysis, this article puts forward three core research questions: First, what are the mainstream means and motives for whitewashing the financial statements of listed companies at present? Second, what identification methods are proposed in the existing literature, and what are the applicability and limitations of various methods? Third, how does the financial statement whitewash distort the intrinsic investment value of listed companies? What are the shortcomings of the existing research? Focusing on these three issues, this article adopts the narrative literature review method to systematically sort out and critically comment on relevant literature at home and abroad, and tries to build an integrated analysis framework between the two fields of financial fraud and enterprise valuation.

2. Theoretical Background

2.1 Definition of Core Concepts

The whitewashing of financial statements conceptually needs to be distinguished from reasonable accounting estimates. Accounting standards themselves provide managers a certain amount of professional judgment space, such as the accrual ratio of asset impairment provisions, the selection of depreciation years, the judgment of the timing of income recognition, etc., which belong to the scope of normal accounting practice. The core feature of financial whitewashing is “deliberately misleading”: managers purposefully choose accounting processing methods or construct transactions to make financial statements inconsistent with the real economic situation [4]. According to the definitions of Cimini and Mechelli, financial information

misstatement can be divided into two forms: when text expression is manipulated, it is called impression management, and when digital information is manipulated, it is called surplus management. The two may be independent or complementary to each other [4].

In this article, the investment value of a listed company specifically refers to the intrinsic value based on the fundamental information of the enterprise. This concept is different from market prices, which may deviate from intrinsic value due to market sentiment, liquidity factors or information asymmetry. Fundamental valuation theory believes that the intrinsic value of an enterprise depends on the present value of future cash flows and the sustainability of profitability, and financial statements are the main channel for external investors to obtain this information [1]. When financial information is whitewashed, investors' judgments based on distorted data are bound to be biased.

2.2 Support the Core Theoretical Framework

The triangular theory of fraud is the most classic framework for explaining the motive of fraud. The theory believes that fraud requires three conditions to be met at the same time: pressure, financial difficulties or performance target pressure faced by individuals or organizations; opportunities, loopholes in internal control or external supervision; rationalization, fraudsters can find moral excuses for their behavior [2, 3]. A systematic review of 25 relevant literature by Suryandari and others shows that 80% of the studies use all three elements, and 60% of the empirical results support the validity of the theory [2]. The theory has been adopted by SAS No. 99, the U.S. audit standard, and has become a standard tool for auditors to assess the risk of fraud. However, critics point out that the "rationalization" dimension is difficult to observe directly, and the theory may not fully cover situational factors and the personal characteristics of fraudsters [2, 3].

The effective market hypothesis provides a theoretical reference for understanding the market consequences of financial whitewashing. In a semi-strong effective market, the stock price should reflect all public information. However, when the financial statements themselves are false, even if the market responds effectively to public information, the stock price still cannot reflect the true value of the enterprise, which means that financial whitewashing fundamentally undermines the normal operation of the market pricing mechanism.

Fundamental valuation theory provides basic analytical logic for understanding the relationship between financial information and investment value. Investors' valuation of a company, whether using the method of cash flow discounting, the price-to-earnings ratio multiple method, or other commonly used valuation models, needs to rely on the data provided by the financial statements as the basis for calculation. In other words, financial statement data is the "raw material" of the valuation model. When the basic data is whitewashed, the valuation is bound to be distorted, which is the fundamental reason why this article discusses financial whitewashing and investment value together.

3. Literature Review

3.1 Research and Combing Related to the Whitewashing of Financial Statements of Listed Companies

3.1.1 Literature Related to Financial Whitewashing Motivation

If you want to understand fraud, you need to systematically study the motivation of financial whitewashing first. Based on the analytical framework of the triangular theory of fraud, the existing literature summarizes the motive of fraud into the interaction of the three dimensions of pressure, opportunity and rationalization [2, 3]. However, there are significant differences in the importance and expression of various dimensions in different institutional environments.

In international studies, a systematic review of 25 documents by Suryandari et al. shows that the opportunity factor has the greatest influence, and 83.3% of the empirical studies that include this variable confirm its positive effect on fraud [2]. Developed markets pay more attention to the driving effect of management compensation incentives and capital market pressure. When executive compensation is closely linked to stock prices or short-term performance, whitewashing statements to maintain stock prices become a rational choice.

The study of fraud motives under the Chinese situation reveals a more complex picture. Through the longitudinal analysis of eight typical financial fraud cases from 1990 to 2022, Liu et al. found that the fraud motive showed a significant trend of evolution from “avoiding losses” to “taking the initiative to make profits” [1]. Between 1990 and 2000, the fraud motives of listed enterprises such as Qiongminyuan Co., Ltd. and Hongguang Industrial Co., Ltd. and other similar cases were mainly to avoid losses or meet the listing qualification requirements, which were directly related to the rigid constraints of “continuous losses are ST/PT” at that time [1]. After entering 2011, the fraud motives of Kangmei Pharmaceutical, Kangdixin and other cases have evolved into “maintaining stock prices” and “realizing performance commitments”, and the service target has shifted from “enterprise survival” to “major shareholder interests” [1]. This evolution means that fraud is changing from “passive survival” to “active grab”.

Based on the rooted research of fraud cases involving five Chinese listed companies such as Lubei Chemical and Wanfushengke, Hu et al. further enriched the understanding dimension of fraud motivation [5]. The three-factor model of “demand-opportunity-culture” proposed by it shows that under the penetration of China's humanistic social culture and official-oriented system, there is a general “acquiesce” mentality for fraud by external regulatory authorities, and a “self-remediation” mechanism for fraud within the enterprise, “No one can do it, or Leave”, “Isn't it all like this” [5]. This cultural factor is rarely discussed in Western fraud theory, but it is an indispensable dimension to explain the fraud motivation of listed companies in China.

3.1.2 Typical Operation Methods for Whitewashing Financial Statements

The operation methods of financial whitewashing continue to evolve with the change of accounting standards and the strengthening of supervision, showing a trend of transformation from simple and rough to hidden and complex. The classification of whitewashing methods in the existing literature mainly revolves around the four dimensions of income manipulation, asset falsification, cash flow modification and related transaction concealment.

The longitudinal case studies of Liu et al. revealed an important evolutionary feature: the fraud methods before 2000 were relatively direct. Qiongminyuan Co., Ltd. fabricated profits by forging contracts and fictitious product sales in the business of Hongguang Industrial Co., Ltd., which was easier to identify under relatively strict audit procedures [1]. After entering 2001, the means of fraud became increasingly hidden: Dalman disguised zircon as a diamond and inflated inventory, taking advantage of the characteristic that the asset value is difficult to estimate; Kangdixin cooperated with counterfeiting through the whole chain of fictitious sales, procurement and production, and the fraud extended to upstream and downstream suppliers and customers [1]. This “whole chain forgery” means that the traditional single-indicator abnormal identification method faces fundamental challenges, and the forgery has been systematically embedded in the complete business process.

From a theoretical perspective, Cimini and Mechelli divide the means of whitewashing into two categories: “impression management” and “surplus management” [4]. Impression management focuses on the manipulation of the form of information presentation, including the selective use of color pictures and charts, violation of graphic construction principles, and the use of the right to choose the disclosure format in the guidelines [4]. Surplus management focuses on the manipulation of accounting figures themselves, including the use of accounting policies to choose elasticity, arrange transaction times, and construct real activities (such as excessive production to dilute unit costs). The two types of means may be used alone or in combination. The rooting study in the context of China points out that the natural diversity of accounting policies themselves and the objective existence of information asymmetry together provide a “natural opportunity” for management to implement whitewashing [5].

3.2 Domestic and Foreign Research on the Identification Method of Financial Statements

3.2.1 Traditional Financial Indicator Identification Method

The logical starting point of the traditional identification method is that when the enterprise implements financial whitewashing, the audit relationship between the items of the financial statements will be abnormal, and some ratios will deviate from the normal level of the industry or its own historical trend. Cimini and Mechelli summarize such methods as “ratio analysis”, which summarizes four core indicators: the ratio of profit volatility to cash flow volatility, the correlation coefficient between total accrued profit and operating

cash flow, the relative scale of total accrued profit, and the relatively small loss of small-profit companies. The proportion of division [4]. These indicators are easy to calculate and have strong data access, and have become the main tools for early empirical research.

However, the limitations of the traditional index method are also obvious. Cimini and Mechelli noted in their review that differences in institutional environments across countries significantly affect the interpretative power of indicators, and that relying solely on financial ratios cannot reliably separate reasonable estimates from deliberate manipulation [4]. It is difficult to distinguish between “reasonable estimation” and “deliberate manipulation” by relying solely on financial ratios [4]. With the complexity of fraud, simple ratio abnormalities may have been “smoothed” by management through systematic fraud, and the detection effectiveness has decreased.

3.2.2 Classic Fraud Identification Model

The evolution of classical models represents the transformation of identification methods from heuristic judgment to statistical modeling. Cimini and Mechelli summarize this evolution as a development trajectory from the “first-generation model” to the “second-generation model” [4].

The core idea of the first-generation model is to break down the total accrued profit into two parts: non-manipulable and maneuverable, the latter acting as an agent variable for surplus management. The early model estimated the normal accrual level through the regression method, taking economic fundamental variables such as changes in operating income and the scale of fixed assets as explanatory variables. The regression residual represents abnormal accrual. On this basis, the revised version further adjusts the handling of income variables and deducts changes in accounts receivable from operating income to eliminate the possibility of management manipulating revenue through credit sales [4].

However, the first-generation model has systematic shortcomings: there are statistical errors when applied to extreme performance samples; the detection effect of reasonable manipulation amplitude in the economic sense is low; and it relies on the strong assumption that “there is no surplus management during the estimated period” [4].

The second-generation model is revised to the above limitations: introducing operating cash flow into the model to control changes in economic fundamentals; incorporating the return on total assets into regression to eliminate the bias caused by extreme performance samples; abandoning the binary assumption of “estimated period-event period” and adopting cross-sectional industry regression to directly estimate abnormal accrual; and Setting the staged variable in the model to check whether the surplus management is reversed in the subsequent period [4]. These improvements have significantly improved the statistical nature of the model, but the core challenges still exist, and researchers still need to make a theoretical preset for the “normal accrual level”.

Azad et al. provide identification evidence from another perspective: identify surplus management by comparing the differences in financial statements before and after audit adjustment [6]. An empirical examination of 159 listed companies on the Tehran Stock Exchange found that the scale of total asset audit adjustment was significantly negatively correlated with the level of surplus management. The greater the audit adjustment, the lower the degree of surplus management [6]. The advantage of this method is to directly observe the game process between management and auditors, rather than relying on indirect statistical estimates.

3.2.3 Emerging Identification Methods: Big Data, Machine Learning and Text Mining

In recent years, the improvement of data accessibility and the enhancement of computing power have given rise to a new paradigm of identification methods. Emerging methods are no longer limited to the abnormal detection of financial figures themselves, but extend to the in-depth mining of text information and unstructured data.

Hanlon et al. combed out a large number of relevant studies in the review from the perspective of behavioral economics, pointing out that the tone, word style and non-verbal behavior of the management meeting speech can convey information about its integrity [7]. For example, some studies have found that by analyzing the voice intonation of the management in the surplus conference call, such as pitch, speed, pause frequency and other acoustic characteristics, the future profit changes of the enterprise can be predicted; another study has

found that there is a financial manager, with business issues, who cites more general knowledge, use fewer positive words, and refer less to shareholder value [7].

Machine learning methods provide technical support for multi-dimensional comprehensive identification. By integrating financial indicators, text characteristics and corporate governance variables into the unified model, a “fraud warning” prediction framework can be built. However, as Hanlon and others pointed out, machine learning has advantages in prediction accuracy, but its “black box” characteristics weaken the interpretability – a trade-off that cannot be ignored for scenarios that need to be clarified to regulators [7].

3.3 Research on the Correlation between Financial Whitewashing and the Investment Value of Listed Companies

3.3.1 The Distortion Mechanism of Enterprise Valuation by Whitewashing Statements

The distortion of investment value by financial whitewashing not only occurs when exposed, but the accumulation of valuation bubbles during the whitewashing period may damage the efficiency of resource allocation more far-reaching. Hanlon et al.'s review of behavioral economics provides a micro-mechanism explanation for understanding this process [7].

Behavioral economics believes that managers are not “rational economic people” assumed by the traditional model, but “sapiens” with limited rationality, non-standard preferences and experience branding [7]. The financial reporting behavior of management is not only driven by economic incentives, but also systematically influenced by personal characteristics such as gender and experience and cognitive deviations such as excessive self-confidence. For example, “overconfident CEOs” who use option holdings to infer were found to be more inclined to manipulate profits, issue overly optimistic forecasts and adopt radical tax planning [7]. The core argument of Hanlon et al. is that financial whitewashing is embedded in the personal characteristics of managers from the root. Not all managers who face the same pressure and opportunities will choose fraud. Personal cognition and moral framework play an important regulating role.

The research of Choudhary et al. reveals another more hidden path of valuation distortion, the economic consequences of “non-significant misreporting” [8]. Through an empirical analysis of the correction of non-major misreports of listed companies in the United States, it is found that even if it is not recognized as “significant”, the misreport correction announcement is still accompanied by a significantly negative market reaction [8]. More importantly, the correction of non-significant misreporting is the leading indicator of future major misreporting, and major defects in internal control and SEC inquiry letters [8]. This means that there may be a large number of “unidentified” information distortions in the market, which have not yet reached the threshold that needs to be restated, but have been subtly eroding the basis of valuation accuracy.

3.3.2 Stock Price Collapse and Long-term Profit Loss after Financial Fraud Exposed

Liu et al. described the multi-dimensional consequences of financial fraud exposure by sorting out typical cases in China's capital market [1]. In terms of stock prices, Kangmei Pharmaceutical's continuous stop loss after the exposure of counterfeiting, Kangdexin's delisting and delisting and other phenomena show that the market punishment is severe and thorough in the short term. In terms of investor protection, the Kangmei Pharmaceutical case, as the first special representative lawsuit after the implementation of the new Securities Law, ruled to compensate investors 2.459 billion yuan, setting a new record for the amount of compensation for A-shares [1]. In terms of criminal responsibility, Zhong Yu, the former chairman of Kangde Xin, was prosecuted for suspected illegal disclosure, fraudulent issuance and other crimes [1]. The evolution at the institutional level shows that the consequences of financial fraud have been extended from “administrative punishment” to the three-dimensional investigation of “civil compensation” and “criminal liability”.

4. Key Finding

In terms of consistency conclusions, existing studies have formed a clear consensus on the following issues: First, the whitewashing of financial statements will destroy the intrinsic investment value of enterprises in the long run. No matter how fraud beautifies the statements in the short term, the value destruction effect after exposure far exceeds any short-term benefits [1, 4]. Second, the fraud triangle theory is widely applicable in

explaining the motives of fraud, and its framework value has been widely supported across countries and industries [2, 3].

Research differences mainly focus on the validity of identifying models. The first-generation and second-generation models differ significantly in terms of sample dependence, detection efficacy and mis-setting risk [4]. In addition, the rooted study in the context of China points out that the “cultural” factor less discussed in Western theories plays a decisive role in China's fraud [5], suggesting the “situational dependence” of fraud motivation research.

The problems to be solved are reflected in three aspects: First, the impact of industry specificity on the identification model has not been systematically incorporated, and there are fundamental differences between the asset characteristics of agriculture, IT and other industries and the manufacturing industry. Second, the existing tools are mainly aimed at professional institutions. For small and medium-sized investors, the use of models has a certain complexity, which constitutes an obstacle to use. Third, the implementation of new income and new leasing guidelines provides new flexibility for whitewashing, but the relevant research is obviously lagging behind.

In terms of research and development context, the identification method has gone through a clear path from “abnormal analysis of single financial indicators” to “multi-factor statistical model” to “artificial intelligence multi-dimensional identification”. The research perspective is moving from “single fraud research” to “cross-study of fraud and valuation”. Choudhary and other discoveries on “non-significant misreporting” [8] and Hanlon and other arguments on the relationship between manager characteristics and reporting behavior [7] all mark the deepening of this cross-trend.

5. Discussion and Synthesis

Although the above research results are rich, from the perspective of integration, there are three levels of structural limitations in the existing literature.

First, the methodological level: identify the separation between research and valuation research. Cimini and Mechelli pointed out in their “Impression Management-Surplus Management Matrix” that existing identification tools either focus on digital manipulation or text manipulation, and rarely study the interaction between the two in annual reports [4]. Similarly, identification model researchers pay attention to “how to detect fraud”, and valuation researchers pay attention to “how fraud affects prices”. There is a lack of mechanical connection between the two fields.

Second, situational level: the specificity of the Chinese situation has not been fully theorized. The “whole chain forgery” [1] revealed by Liu et al. and the “demand-opportunity-culture” model [5] refined by Hu et al. both show that China's institutional environment and cultural traditions make fraud different characteristics from the West. However, most classic models are developed based on American data, and their applicability test in the Chinese market is relatively insufficient.

Third, the existing tools are mainly aimed at auditing and professional institutions. These topics have a large amount of data and technical resources. However, A-shares are a retail-based market. A large number of investors have limited information, and decision-making can only rely on limited public materials. The lack of identification schemes for ordinary people has caused a significant gap between research and actual needs.

Based on the above analysis, this paper puts forward three future research directions. First, the differentiated identification and valuation revision framework should be built by industry. The valuation of biological assets of agriculture, forestry, animal husbandry and fishery. The judgment of the completion percentage method of engineering construction, and the capitalization of R&D expenditure of software. All need to be targeted identification plans. Second, combine with the AI lightweight model to develop screening tools that can be used by ordinary investors, extract core features on the basis of complex models, and make academic achievements truly serve market practice. Third, pay attention to new income and new whitewashing methods under leasing guidelines and their impact on valuation, track the impact of standard changes on reporting behavior, and update the identification framework in a timely manner.

6. Conclusion

This article systematically sorts out relevant literature at home and abroad around the three main lines of the motivation and means of whitewashing financial statements, identification methods and the distortion effect of investment value. In terms of whitewashing motives, the fraud motive has evolved from “avoiding losses and protecting the shell” to “actively seeking profits”, and the operating means have been upgraded from “simple fiction” to “whole-chain forgery”. At the level of identification methods, the methodology has undergone a clear evolution from ratio analysis to statistical modeling to the comprehensive identification of artificial intelligence, but there are still significant differences in the applicable boundaries and detection effectiveness of various methods in different situations. At the level of value distortion, whitewashing not only destroys the value through the collapse of the exposed stock price, but also the gradual erosion of the valuation system during the whitewashing is more profound.

The theoretical contribution of this article is that it systematically integrates two relatively independent fields of financial whitewashing identification and investment value evaluation, and puts forward the whole-chain analysis perspective of “identification-distortion-repair”, which provides an integrated framework for follow-up research. The practical contribution lies in summarizing the feasible financial report screening ideas, clarifying the applicable conditions and limitations of existing tools, revealing the difficulties faced by small and medium-sized investors and pointing out the feasible direction. The analysis of this article shows that investors cannot rely on any single identification tool, but need to understand the incentive structure of the management, pay attention to the unique risks of the industry, and be sensitive to the change of criteria. These three are indispensable.

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Funding

This research received no external funding.

Conflicts of Interest

The authors declare no conflict of interest.

Acknowledgment

This paper is an output of the science project.

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