



WILL DIGITAL TRANSFORMATION AFFECT CORPORATE FINANCIAL RESTATEMENTS?

Qianwen Sun¹ and Xunchun Sun²

¹School of Accounting and Finance, Hong Kong Polytechnic University, Hong Kong, China.
Email: 23097172g@connect.polyu.hk

²School of Management, Qufu Normal University, Rizhao, Shandong, China, 276826.
Email: sxczy@163.com

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ABSTRACT: *With the rapid development of digital technology, digital transformation has become an important driving force for enterprise development, bringing new challenges and opportunities to corporate governance. This study empirically examines the impact of digital transformation on financial restatements by analyzing a sample of non-financial listed companies on the Shanghai and Shenzhen A-share markets in China from 2011 to 2020. The results show that digital transformation significantly reduces the likelihood of financial restatements through three main mechanisms: improving the quality of internal control, reducing information asymmetry, and enhancing executive compensation incentives. Further analysis indicates that the inhibitory effect of digital transformation on financial restatements is more pronounced in state-owned enterprises, high-tech companies, and those with prominent agency problems. This study provides valuable references for improving corporate governance practices in Chinese enterprises.*

KEYWORDS: Digital transformation, Financial restatements.



INTRODUCTION

With the rapid development of digital technologies, including cloud computing, 5G, and the Internet of Things, digital transformation has become a key catalyst for innovation and change in global enterprises.

However, digital transformation has also intensified governance challenges in the capital market, with frequent financial restatements. For instance, in 2019, Kangmei Pharmaceutical's market value plummeted due to accounting errors. Financial restatements not only reflect internal control deficiencies and insufficient information transparency within enterprises but may also be caused by management's use of information asymmetry for earnings manipulation (Ettredge et al., 2010). Research indicates that digital transformation can curb financial restatements by enhancing internal control quality (Gao, 2016), alleviating information asymmetry, and optimizing executive compensation incentives (Burns & Kedia, 2006).

Based on this, this paper, under the background of digital economic development, selects Chinese A-share listed companies from 2011 to 2020 as research samples to explore how digital transformation affects financial restatements. I hope this paper can provide empirical support for understanding the role of digital transformation in financial reporting and offer a reference for enterprises implementing digital transformation.

LITERATURE REVIEW AND RESEARCH HYPOTHESES

Enterprise Digital Transformation

Enterprise digital transformation is typically defined as a comprehensive transformation of a company's business model, operational processes, and organizational structure through the application of digital technologies such as big data, artificial intelligence, cloud computing, and the Internet of Things (Klos et al., 2021). This is not only a technological advancement but also a strategic move. Through digital transformation, enterprises enhance their risk tolerance (Tian et al., 2022), improve their performance levels and also increase audit quality (Zhai & Li, 2022).

Financial Restatements

Financial restatements refer to the process by which enterprises correct errors in disclosed financial information. Financial restatements can be roughly divided into two categories. The first category involves enterprises fraudulently altering financial statements for the purpose of earnings management. The second category consists of non-fraudulent corrections of accounting errors, which are caused by human mistakes or policy changes. Currently, research on the motives for financial restatements mainly focuses on the first category.

Research Hypotheses

Whether it is an unintentional oversight or an intentional fraud, it reflects the deep-seated problems of ineffective internal control or insufficient information transparency in the corporate governance system. With the rapid penetration of digital technology, enterprises are gradually achieving standardized business processes, real-time data interaction, and intelligent



decision support by integrating tools such as artificial intelligence, blockchain, cloud computing, and big data. Against this backdrop, this study proposes the core hypothesis.

Hypothesis 1: *The digital transformation of enterprises reduces the possibility of financial statement restatements.*

As digital technology is increasingly integrated into business operations and management, it creates a favorable internal governance environment for enterprises, helps identify potential risks, improves the efficiency of information transmission, and strengthens internal control supervision, thereby optimizing the company's internal control system. Internal control is an important supervisory mechanism to ensure the reliability of financial reports. Therefore, digital transformation can reduce the possibility of financial restatements by improving the quality of internal control.

In view of this, the following research hypothesis is proposed:

Hypothesis 2: *Enterprise digital transformation reduces the occurrence of financial restatements by enhancing the quality of internal control.*

Digital transformation effectively alleviates the information asymmetry between enterprises and their stakeholders by enhancing the internal information processing capabilities and external information transparency of organizations. On the one hand, digital transformation undoubtedly improves the efficiency of internal information flow within organizations and the ability to process and analyze massive amounts of data, thereby promoting the effective transmission of information and ensuring the reliability of accounting information. On the other hand, digital transformation can strengthen the relationship between enterprises and their stakeholders, which helps to reduce the information asymmetry between organizations and external stakeholders and ensures that stakeholders can obtain accounting information with minimal error. Based on the above situation, the following research hypothesis is proposed:

Hypothesis 3: *The digital transformation of enterprises reduces the occurrence of financial restatements by reducing information asymmetry.*

Digital transformation, by reconfiguring business models and governance systems, drives the optimization of executive compensation mechanisms towards long-term and performance-based directions. On one hand, digital tools (such as big data analytics and intelligent monitoring systems) enhance the quantifiability of management efficiency, enabling enterprises to more accurately link compensation with productivity and innovation achievements, and reducing the motivation for short-term earnings manipulation. On the other hand, digital transformation strengthens the enterprise's value creation capacity, prompting compensation design to focus more on long-term incentives (such as equity and options), binding the interests of executives to the sustainable development of the enterprise, and alleviating agency conflicts.

Based on this, the hypothesis is proposed:

Hypothesis 4: *Enterprise digital transformation reduces the occurrence of financial restatements by promoting executive compensation incentives.*



RESEARCH DESIGN

Sample Selection and Data Sources

This study employs panel data of Chinese A-share listed companies from 2011 to 2020. During the initial data screening process, samples of delisted companies, ST and *ST companies were excluded, as well as those with missing relevant variables. A total of 24,620 observations were obtained. The data in this paper are sourced from the CSMAR database and the Dibble database.

Variable Definition

- 1) *Measurement of Financial Restatements:* Existing research on financial restatements is rather cursory and typically measures restatements by constructing dummy variables. Following the approach of He and Fang (2021), if a company's annual report for the current year contains material accounting errors that require financial restatements in subsequent years, it is assigned a value of 1; otherwise, it is assigned a value of 0.
- 2) *Digitalization Index Measurement:* Existing studies typically use word frequency statistics to measure digital transformation variables, focusing on the occurrence of terms such as artificial intelligence, blockchain, cloud computing, big data, and digital technology in corporate annual reports. This paper utilizes the enterprise digital transformation index developed in collaboration with the research team of East China Normal University, which is more comprehensive than the indicators used in previous literature and can accurately reflect multiple aspects of an enterprise's digital transformation.
- 3) *Control Variables:* Based on relevant research, the selected control variables are: return on assets (ROA), asset capital structure (LEV), company size (Size), years of listing (Age), board size (Board), proportion of independent directors (Indep), company growth (Growth), and audit quality (Audit). Industry and year are also controlled.

Model Construction

To examine the impact of digital transformation on financial restatements of enterprises, the following regression model is constructed:

$$\text{Logit}(\text{Restate}_{i,t}) = \alpha_0 + \beta_1 \text{Digitizing}_{i,t-1} + \beta_2 \text{Controls}_{i,t-1} + \sum \text{industry} + \sum \text{year} + \varepsilon_{i,t} \quad (1)$$

The dependent variable is the financial restatement behavior of enterprises ($\text{Restate}_{i,t}$), and the independent variable is the degree of digital transformation of enterprises in period t-1 ($\text{Digitizing}_{i,t-1}$). Considering that the impact of digital transformation on financial restatements of enterprises may have a certain time lag, and to alleviate the endogeneity of reverse causality in model variables, the digital transformation variable and control variables of enterprises in period t-1 are adopted. $\text{Controls}_{i,t-1}$ is a set of control variables for period t-1. $\varepsilon_{i,t}$ is the random error term; α_0 is the constant term.



EMPIRICAL RESULTS

Benchmark Regression

TABLE I. RESULTS OF REGRESSION

	(1) Restate	(2) Restate	(3) Restate	(4) Restate	(5) Restate
Digitizing _{t-1}	-0.046***	-0.038***	-0.039***	-0.027**	-0.027**
	(-5.5290)	(-3.1803)	(-3.2567)	(-2.2461)	(-2.1686)
ROA _{t-1}			-0.297***	-0.196***	-0.171***
			(-7.6723)	(-4.8852)	(-4.1605)
LEV _{t-1}				0.105***	0.098***
				(6.5970)	(6.1654)
Size _{t-1}				-0.014***	-0.013***
				(-5.9153)	(-5.5429)
Age _{t-1}				0.013*	0.012*
				(1.8335)	(1.7806)
Board _{t-1}				0.005	0.005
				(0.3446)	(0.3402)
Indep _{t-1}				0.000	0.000
				(0.6699)	(0.6568)
Growth _{t-1}					0.012**
					(2.1423)
Audit _{t-1}					0.085***
					(4.0987)
_cons	0.290***	0.338***	0.349***	0.508***	0.488***
	(9.7540)	(6.2025)	(6.4004)	(6.9614)	(6.6789)
Year FE	No	Yes	Yes	Yes	Yes
Industry FE	No	Yes	Yes	Yes	Yes
N	20941	20941	20941	20941	20941
r ² _a	0.001	0.022	0.025	0.028	0.029

As shown in Table 1, the first column presents the regression results without controlling for year and industry fixed effects, while columns (2) to (5) show the regression results after controlling for year and industry fixed effects and successively adding control variables. The results indicate that, with the successive addition of control variables, the coefficient of the impact of digitalization on financial restatements is consistently negative and significant,



suggesting that digitalization significantly reduces the likelihood of financial restatements, thereby verifying the validity of Hypothesis 1.

Analysis of Impact Mechanisms

Existing research indicates that the digital transformation of enterprises can reduce the possibility of financial restatements. The main reasons are as follows:

(1) Strengthening internal control: Digital transformation improves the internal control environment and enhances the efficiency and effectiveness of risk assessment. This enables companies to implement intelligent control measures and strengthen internal supervision mechanisms, thereby enhancing internal control and reducing the occurrence of financial restatements.

(2) Improving information transmission: The digital transformation of an organization enhances the efficiency of information dissemination and processing. It promotes communication between the enterprise and its stakeholders, thereby reducing information asymmetry and ultimately lowering the possibility of financial restatements.

(3) Enhancing enterprise value and responsibility: Digital transformation promotes enterprise development, enhances the capabilities of senior management, and increases the overall value of the enterprise. Well-designed compensation incentives help alleviate agency problems and minimize false statements. Additionally, differences in internal executive compensation may motivate management to fulfill their duties, further reducing the incidence of financial restatements.

Based on these insights, this paper examines the impact of digital transformation on financial restatements through three mechanisms: internal control quality, the degree of information asymmetry, and compensation incentives. To analyze these pathways, based on Bauer's research, we have developed the following model to assess how digital transformation affects financial restatements.

$$\text{Logit}(\text{Restate}_{i,t}) = \beta_0 + \beta_1 \text{Digitizing}_{i,t-1} + \beta_j \text{Controls}_{i,t-1} + \sum \text{industry} + \sum \text{year} + \varepsilon_{i,t} \quad (2)$$

$$M = \alpha_0 + \alpha_1 \text{Digitizing}_{i,t-1} + \alpha_2 \text{Controls}_{i,t-1} + \sum \text{industry} + \sum \text{year} + \varepsilon_{i,t} \quad (3)$$

$$\text{Restate}_{i,t} = \beta_0 + \beta_1 \text{Digitizing}_{i,t-1} + \beta_2 M + \beta_j \text{Controls}_{i,t-1} + \sum \text{industry} + \sum \text{year} + \varepsilon_{i,t} \quad (4)$$

In the selection of mediating variable M , internal control quality (ICt-1) is measured by dividing the internal control index of listed companies in the Dibble database by 100; analysts' attention can increase the dissemination of corporate information to the outside world, so the degree of information asymmetry (inasyt-1) is measured by using the degree of analysts' attention; and monetary compensation, which is the most common form of executive incentives, is measured by drawing on the methodology of Yang et al. (2014). The top three executives' salaries (SalaryTt-1) and the internal management pay gap (SalaryGt-1) are used to measure executive compensation in multiple ways. Of these, the internal management pay gap is calculated as follows:

The absolute gap in compensation within management $\text{MWD} = \text{Total compensation of top three directors, supervisors, and executives} / 3 - (\text{Total number of directors, supervisors, and executives} - 3)$

The regression results are summarized in the table below

TABLE II. REGRESSION RESULTS OF THE INFLUENCE MECHANISM

	(1) IC _{t-1}	(2) Restate	(3) inasy _{t-1}	(4) Restate	(5) SalaryT _{t-1}	(6) Restate	(7) SalaryG _{t-1}	(8) Restate
Digitizing _{t-1}	0.177***	-0.025**	3.602***	-0.023*	4.8e+05***	-0.025**	1.7e+05***	-0.025**
	-4.5827	(-2.0241)	-12.2796	(-1.8970)	-6.173	(-2.0612)	-5.5433	(-2.0739)
IC _{t-1}		-0.010***						
		(-3.9669)						
inasy _{t-1}				-0.001***				
				(-3.3936)				
SalaryT _{t-1}						-0.000***		
						(-2.8362)		
SalaryG _{t-1}								-0.000***
								(-2.6874)
_cons	2.774***	0.516***	-77.478***	0.418***	-1.6e+07***	0.443***	-5.9e+06***	0.448***
	-10.9516	-7.0366	(-40.4945)	-5.4098	(-26.9982)	-5.8892	(-25.5349)	-5.977
Year FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Industry FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
N	20940	20940	20941	20941	20941	20941	20941	20941
r ² _a	0.247	0.03	0.351	0.03	0.236	0.029	0.223	0.029

1) *Internal Control Mechanisms*: Columns (1) and (2) of Table 2 present the regression results for the mediating role of internal control quality. Column (1) shows that the coefficients of digital transformation (Digitizing_{t-1}) and internal control quality (IC_{t-1}) are significantly positive at the 1% level, indicating that digital transformation significantly enhances internal control quality. In Column (2), after adding IC_{t-1}, the coefficients of IC_{t-1} and financial restatement (Restate) are both significantly negative at the 1% level, suggesting that digital transformation reduces the occurrence of financial restatements by improving internal control quality.

2) *Information Asymmetry*: The mediating effect of information asymmetry is shown in Columns (3) and (4) of Table 2. Column (3) reveals that the coefficients of Digitizing_{t-1} and analyst attention (inasy_{t-1}) are significantly positive at the 1% level, implying that digital transformation alleviates information asymmetry. Column (4) demonstrates that the coefficient of inasy_{t-1} on Restate is significantly negative at the 1% level, confirming that digital transformation mitigates financial restatements by reducing information asymmetry.

3) *Executive Compensation Incentives*: The regression results for executive compensation incentives are presented in Columns (5) and (6) of Table 2. The coefficients of Digitizing_{t-1} on the compensation of the top three executives (SalaryT_{t-1}) and the internal pay gap (SalaryG_{t-1}) are significantly positive at the 1% level, indicating that digital transformation increases executive compensation and widens internal pay gaps. Columns (2) and (4) show that both compensation variables negatively affect Restate at the 1% level, demonstrating that digital transformation reduces financial restatements through enhanced compensation incentives.



Heterogeneity Analysis

1) *Ownership Structure*: Digital transformation enables firms to better leverage digital technologies and online platforms for financing, market expansion, and operational activities, thereby alleviating resource inequality in traditional financial markets. State-owned enterprises (SOEs), which already possess strong financing capabilities in traditional markets, exhibit weaker incremental governance effects from digital transformation compared to non-SOEs (Tang et al., 2020). Additionally, SOEs face lower competitive pressures, leading to weaker innovation incentives and less motivation for digital adoption (Wu et al., 2021). Consequently, this study predicts that the inhibitory effect of digital transformation on financial restatements is more pronounced in non-SOEs. The sample is divided into SOEs and non-SOEs based on ultimate controlling shareholders. As shown in Table 3, Column (1), the coefficient of Digitizing_{t-1} on *Restate* is insignificant for SOEs. In contrast, for non-SOEs, Digitizing_{t-1} shows a significantly negative coefficient (-0.07), indicating that digital transformation more effectively suppresses financial restatements in non-SOEs, consistent with expectations.

2) *Technological Attributes*: Digital transformation requires foundational conditions that vary across firms with different technological attributes. High-tech firms prioritize digital technologies in production and operations, applying them across diverse scenarios to optimize processes and enhance information efficiency, resulting in higher digital transformation levels. Thus, this study hypothesizes that high-tech firms amplify the negative correlation between digital transformation and financial restatements. Using high-tech industry classification as a proxy for technological attributes, Table 3 Column (3) shows that Digitizing_{t-1} has a significantly negative coefficient (-0.008) on *Restate* for high-tech firms, while no significant relationship exists for non-high-tech firms. This confirms that digital transformation more effectively mitigates restatements in technology-intensive enterprises.

3) *Agency Costs*: Agency problems are a key driver of financial restatements, as managers may manipulate earnings to maximize personal gains. Firms with higher agency costs are more prone to restatements. Digital transformation alleviates such conflicts by improving internal controls and market transparency. This study predicts stronger governance effects of digital transformation in firms with high agency costs.

Agency costs are measured as the ratio of cash paid for other operating activities to operating revenue (Xie & Huang, 2013). The sample is split into high- and low-agency-cost groups based on the median value. Table 3 Column (5) reveals that Digitizing_{t-1} has a significantly negative coefficient (-0.007) on *Restate* for high-agency-cost firms, while no significance is observed for low-agency-cost firms. This underscores that digital transformation more effectively curbs restatements in firms with severe agency issues.



TABLE III. HETEROGENEITY TEST RESULTS

	(1) State-owned	(2) Non-state-owned	(3) High-tech	(4) Non-high-tech	(5) High agency costs	(6) Low agency costs
	Restate	Restate	Restate	Restate	Restate	Restate
Digitizing _{t-1}	-0.002	-0.007**	-0.008**	-0.003	-0.007**	0.005
	(-0.4439)	(-2.1353)	(-2.5633)	(-0.6722)	(-2.4920)	(1.4117)
ROA _{t-1}	-0.217**	-0.164***	-0.200***	-0.168**	-0.183***	-0.147**
	(-2.3065)	(-3.3081)	(-3.5009)	(-2.5257)	(-3.4921)	(-2.1746)
LEV _{t-1}	0.041	0.100***	0.101***	0.057**	0.065***	0.111***
	(1.5034)	(4.2942)	(4.2585)	(2.2182)	(3.1116)	(4.4916)
Size _{t-1}	-0.009***	-0.010**	-0.011**	-0.013***	-0.013***	-0.015***
	(-2.7772)	(-2.2789)	(-2.4481)	(-3.7687)	(-4.2104)	(-3.9561)
Age _{t-1}	0.030**	0.019*	-0.004	0.023**	0.014	-0.000
	(2.3260)	(1.6548)	(-0.3095)	(2.0752)	(1.5308)	(-0.0199)
Board _{t-1}	0.055**	-0.033	-0.021	0.018	0.004	0.017
	(2.4234)	(-1.3592)	(-0.8909)	(0.8222)	(0.1945)	(0.7173)
Indep _{t-1}	0.000	0.001	0.001	-0.000	0.000	0.001
	(0.0025)	(0.7452)	(0.7490)	(-0.1268)	(0.3790)	(1.5058)
Growth _{t-1}	-0.004	0.014*	0.033***	0.002	0.020***	0.005
	(-0.5312)	(1.7538)	(3.5248)	(0.5323)	(2.6326)	(0.9563)
Audit _{t-1}	0.080*	0.089***	0.116***	0.075**	0.096***	0.091**
	(1.7998)	(3.1827)	(3.2104)	(2.4634)	(3.4565)	(2.4890)
_cons	0.337***	0.307***	0.508***	0.324***	0.405***	0.500***
	(3.0799)	(2.6612)	(3.6021)	(3.3253)	(4.7361)	(4.2665)
Year FE	Yes	Yes	Yes	Yes	Yes	Yes
Industry FE	Yes	Yes	Yes	Yes	Yes	Yes
N	6899	10071	9017	7943	12038	8293
r ² _a	0.050	0.030	0.042	0.031	0.028	0.032

CONCLUSION

This study examines the role of digital transformation in reducing financial restatements among Chinese non-financial listed firms from 2011 to 2020. The results demonstrate that digital transformation significantly lowers the likelihood of financial restatements through three mechanisms: enhancing internal control quality, reducing information asymmetry, and strengthening executive compensation incentives. The effects are particularly pronounced in non-SOEs, high-tech firms, and companies with higher audit quality. Policymakers and corporate managers should prioritize digital transformation initiatives to improve financial



transparency and governance efficacy, thereby fostering sustainable development in dynamic business environments.

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