IDENTIFYING CONTROL DEFICIENCIES – AN IMPORTANT COMPONENT OF MANAGEMENT'S ASSESSMENT

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ABSTRACT. Ashbaugh-Skaife et al. identify a sample of 2,103 firms that have disclosed the quality of their internal control and also have sufficient financial statement data to calculate our accrual quality measures. Stephens examines the impact of corporate governance quality on ICD disclosure/ nondisclosure in the SOX 302 regime, and the impact of corporate governance quality on the accurate assessment of the seriousness of the ICD.
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1. Introduction

Ashbaugh-Skaife et al. use firm size as measured by the market value of equity (SIZE), the percentage of the last three years that a firm reports losses (%LOSS), and financial distress as measured by the ranked value of the Altman (1968) Z-score (ZSCORE) to control for these effects on accrual quality. Ashbaugh-Skaife et al. assume that major GAAP accounting choices are common within an industry, and control for this effect by estimating abnormal accruals within industry classification (abnormal accruals for both ICD and control firms are adjusted for common industry accounting choices). The increased variance and bias in accrual accounting earnings relative to operating cash flows caused by conservative accounting leads Ashbaugh-Skaife et al. to predict a positive relation between accounting conservatism and our accrual quality proxies, and use the book to market ratio (B/M) to proxy for the degree of conservatism in firms' accounting choices, where lower values indicate more conservative accounting. Firms that contract with the largest audit suppliers, who have brand name reputations to protect, will be associated with higher quality accruals. Stephens creates an indicator variable equal to one if the company's CFO has a CPA license or has worked for a public accounting firm and zero otherwise, and hypothesizes that companies that have CFOs that have greater financial accounting background are more likely to discover and disclose weaknesses in their internal controls under section 302. Stephens expects companies with audit committees that have accounting expertise (ACOMMEXP) to be more likely to disclose ICDs under section 302. Stephens holds constant the existence of internal control weaknesses in order to examine the impact of audit committee quality on the discovery and disclosure of ICDs as well as the accuracy of the ICD severity assessment. Stephens sets ACOMMEXP equal to one if the audit committee has at least one "accounting financial expert" on the committee during 2004 and 0 otherwise, and hypothesize that companies that have audit committees with at least one "accounting financial expert" are more likely to discover and disclose ICDs prior to their first SOX 404 report than companies without such accounting financial expertise.

2. Improvements in accruals quality

The three measures of accruals quality that Ashbaugh-Skaife et al. examine are: (1) the degree to which accruals map into cash flows (WCA_NOISE); (2) absolute value of abnormal total accruals (AB_ACC); and (3) absolute value of abnormal working capital accruals (AB_WCACC). Ashbaugh-Skaife et al. expect ICD firms to have a weaker mapping of accruals to cash flows as poor estimates or lack of control over accrual adjustments results in accruals that are never realized. Ashbaugh-Skaife et al. predict a positive relation between WCA_NOISE and the presence of an ICD, and expect ICD firms to have larger absolute value of abnormal total accruals, and larger abnormal working capital accruals relative to control firms (the unintentional and intentional errors in accrual estimates or accrual adjustments will not be explained by firms' innate operating characteristics). Ashbaugh-Skaife et al. predict a positive relation between AB_ACC and AB_WCACC and the presence of an ICD, and expect accrual quality to improve when internal control deficiencies are remediated as evidenced by the internal control audit opinion. Ashbaugh-Skaife et al. identify a sample of 2,103 firms that have disclosed the quality of their internal control and also have sufficient financial statement data to calculate our accrual quality measures. By documenting the quality of accruals in 2003, Ashbaugh-Skaife et al. are able to assess whether the remediation of internal control problems in 2004 had an effect on firms' accruals quality. The independent variables as a whole explain a significant portion of firms' accruals quality. Ashbaugh-Skaife et al. find the coefficient on ICD to be significantly positive after controlling for innate firm characteristics that affect accruals quality (firms with internal control problems report larger abnormal total accruals, larger abnormal working capital accruals, and noisier working capital accruals). Firms that report ICDs report lower quality accruals relative to non-ICD firms. Firms that failed to remediate previously disclosed control problems continue to exhibit significantly higher abnormal accruals relative to non-ICD firms. The ICD firms that corrected their control problems display smaller abnormal accruals after controlling for other innate firm characteristics that affect accrual quality. Firms that remediate their internal control problems report significantly lower abnormal total accruals relative to firms that have not corrected their internal control problems. Firms that remediate their internal control problems, as evidenced by receiving an unqualified auditor's opinion on internal controls, exhibit significant improvements in accruals quality.

Ashbaugh-Skaife et al. investigate whether the presence of internal control problems and the remediation of internal control problems manifest in predictable differences in accruals quality across firms. Firms that continue to report internal control problems experience no change in their accruals quality. As Ashbaugh-Skaife et al. put it, the remediation of internal control deficiencies is associated with improvements in accruals quality. The magnitude of abnormal accruals potentially declines for all firms due to the increase in SEC oversight of financial reporting as a result of SOX. Firms that continue to have weak internal controls show no improvements in accruals quality even in the presence of heightened financial reporting oversight. Strong internal controls improve the quality of firms' financial reporting. Strong internal controls provide a significant long term benefit to investors by reducing both intentional and unintentional errors in measuring, recording and processing financial information that leads to higher quality financial statements. Ashbaugh-Skaife et al. conduct cross-sectional tests to assess whether the presence of internal control weaknesses contributes to lower quality accruals as measured by how well accruals map into past, present and future operating cash flows and by the absolute value of abnormal accruals. Firms that disclose internal control deficiencies exhibit greater noise in accruals and greater absolute abnormal accruals.

3. The impact of corporate governance quality on the accurate assessment of the seriousness of the ICD

Stephens expects companies with fewer financial resources to be less likely to discover and disclose ICDs under section 302. To control for other factors not explicitly controlled for relating to internal control reporting quality under section 302, Stephens includes a size control variable (SIZE) equal to the natural log of total assets. Higher quality corporate governance increases the reporting quality of ICDs in the absence of external audit reporting requirements. Companies that are audited by industry specialized auditors and that have an accounting financial expert on their audit committee are significantly more likely to disclose ICDs during the 3 quarterly filings prior to their first SOX 404 audit report. Companies that have shorter auditor/client relationships are more likely to report ICDs under section 302 reporting requirements. Stephens examines the impact of corporate governance quality on ICD disclosure/nondisclosure in the SOX 302 regime, and the impact of corporate governance quality on the accurate assessment of the seriousness of the ICD. Stephens examines only companies that disclosed an ICD under the SOX 302 regime, grouping the disclosing companies as to whether they accurately reported the ICD as a "material weakness" or as the less-severe "significant deficiency." The CFOs accounting background, the institutional ownership concentration, and the financial condition of the company impact the accurate assessment of the seriousness of the ICD. Companies with more highly concentrated institutional ownership are more likely to classify their ICD as a significant deficiency. Improving the audit committee and the external auditor may help improve the likelihood of disclosures in a setting void of the external audit requirements. Companies with poor financial performance are more likely to accurately assess the seriousness of the ICD (companies with poor financial health are more likely to have poor controls which are easier to identify). Companies that have more highly concentrated institutional ownership have fewer or less severe control problems than their counterparts.

Stephens examines the corporate governance quality impact on firm reporting of internal control deficiencies (ICDs) prior to SOX-mandated audits. Companies that were audited by industry leading auditors, and that have higher quality audit committees are more likely to disclose ICDs under the SOX section 302 regime. Companies that have a CFO with financial accounting experience are more likely to accurately assess the seriousness of ICDs and classify them properly as material weaknesses rather than the less-serious significant deficiencies. The quality of the external auditor and audit committee impact the likelihood of *disclosure* of the ICD in the absence of external audit report requirements. Higher quality corporate governance leads to a higher probability of ICD disclosure in the SOX 302 regime when audits of internal controls were not required. Improving the audit committee and the external auditor may help improve the likelihood of disclosures in a setting void of the external audit requirements. Longer auditor tenure is associated with decreased likelihood of ICD disclosure under SOX 302. Longer auditor/client tenure results in a lack of independence and therefore lowers quality reporting.

4. Conclusion

Ashbaugh-Skaife et al. discuss the coefficients on the control variables from all three models of accruals quality. Ashbaugh-Skaife et al. find significantly negative coefficients on AUDITOR and SIZE, suggesting that firms that hire an audit firm with brand name recognition to protect and are larger in size report lower total abnormal accruals, lower working capital abnormal accruals, and less noisy accruals. Firms with greater inventory levels, more unpredictable cash flows from operations and more volatile sales report lower quality accruals. Firms with foreign sales have smaller abnormal accruals but more noisy accruals. Firms with more business segments have higher abnormal total and abnormal working capital accruals. High growth firms report more abnormal accruals but have a better mapping of accruals to cash flows. Stephens finds no evidence in the multivariate tests that the financial accounting background of the CFO impacts the reporting quality of ICDs: the audit committee, who is charged with oversight of the financial reporting process, more directly influences the reporting of discovered ICDs. Companies with poorer financial health (SUM_LOSS) are significantly more likely to disclose weaknesses during the 3 quarterly filings prior to their first SOX 404 report. Companies with poorer financial health may have more pervasive or serious control problems coming from their inability to invest in internal controls. Ashbaugh-Skaife et al. use the number of operating segments (SEGMENTS) and whether the firm has foreign sales (FOREIGN_SALES) to capture these effects, and use the decile rank value of sales growth (GROWTH) and inventory investments as a percentage of total assets (INVENTORY) as proxies for these effects on accrual quality. Ashbaugh-Skaife et al. include the standard deviation of operating cash flows (STDCFO) and the standard deviation of sales (STDSALES) to proxy for the effects of the volatility of operations on accruals quality. Ashbaugh-Skaife et al. provide evidence on potential benefits of SOX in terms of the effects of strong internal controls on the quality of firms' financial information. The internal control reporting requirements of Sarbanes-Oxley will result in higher quality financial reporting.

REFERENCES

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