

**REPORTS ON INTERNAL CONTROL AND LITIGATION RISK**

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**ABSTRACT**

*In recent years, the Treadway Commission, the General Accounting Office (GAO), the Public Oversight Board (POB) and Board of Directors of the American Institute of Certified Public Accountants (AICPA), among others, have recommended that public companies include in their annual financial statements a management report on internal controls (RIC). The POB and the GAO also have recommended increased auditor involvement in such reporting on internal control. This paper investigates whether the issuance of a RIC (currently voluntary) by public companies is associated with three measures which proxy for litigation risk: industry membership, financial stress, and composition of assets. The results indicate that high-tech companies, companies with higher financial stress, and companies with a higher proportion of total assets in receivables and inventory were less likely to include a RIC in annual financial statements.*

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## INTRODUCTION

Management reporting on internal controls has been of significant interest to the public accounting profession in recent years. Legislators, the General Accounting Office (GAO), and the American Institute of Certified Public Accountants (AICPA) have suggested that management's report on internal control (RIC) provides useful information to financial statement users and should be mandated for public companies [U.S. House of Representatives 1985, 1990, 1991; AICPA 1993; Public Oversight Board (POB) 1993; GAO 1996]. The POB [1993] and the GAO [1996] went one step further by recommending that auditors be required to express an opinion on such assertions by management. Recently, the Financial Executives Institute (FEI), the Institute of Management Accountants (IMA) and the Institute of Internal Auditors (IIA) have called for internal control reports, and the SEC is again examining the issue of RICs [FEI 1999; Turner 1999; IIA 2000; Hermanson 2000].

These recommendations may be related to beliefs that RICs would lead to enhanced internal controls by: (a) increasing the internal control awareness of top management, and (b) signaling management's commitment to internal controls and sending a clear

message within the organization about the expected control environment [POB 1993; Treadway Commission - National Commission on Fraudulent Financial Reporting - 1987]. Currently, while some companies voluntarily include a RIC in their audited financial statements, many companies do not choose to include a RIC.<sup>1</sup>

Auditors and others have noted on many occasions that securities class-action litigation has a "chilling effect" on corporate communications and discourages voluntary disclosure of relevant information [Adler 1993; Mednick and Peck 1994]. This paper examines if there is a relationship between the inclusion of a RIC in audited financial statements and conditions associated with securities class-action litigation involving a company's auditors. The results suggest that companies that may be subject to a greater threat of securities litigation are less likely to include a RIC in audited financial statements, and are consistent with suggestions that securities class-action litigation risk may adversely affect voluntary disclosures by companies.

The remainder of the paper is divided into four parts: Background and Hypothesis; Method; Results; and Summary. The following section discusses internal control reporting and the risk of securities class-action litigation, and develops the hypothesis examined in this paper. The next section presents the method

employed in the investigation conducted in the paper; this section is followed by the section on the results obtained from the investigation, and the paper ends with a summary and discussion.

### **BACKGROUND AND HYPOTHESIS**

**T**his section is comprised of three subsections. The focus of this section is on the background about internal control reporting and the risk of securities class-action litigation. In addition, the hypothesis, which is examined in this paper, is developed.

#### **Reporting on Internal Control**

Internal control reporting is the only area where Congress has enacted specific laws related to accounting practice and disclosures by public companies, since the enactment of the Securities Act of 1933 and the Securities Exchange Act of 1934.<sup>2</sup> The Foreign Corrupt Practices Act (FCPA) requires all public companies to have effective internal accounting controls dealing with (1) authorization of transactions, (2) recording of transactions, (3) safeguarding of assets, and (4) periodic physical verification of recorded assets.

As noted by McMullen et al. [1996] there is a distinction between internal controls as they relate to financial reporting and other controls that do not relate to financial reporting (for example, operational and administrative controls). Further, internal controls

that pertain to financial reporting can, in turn, be categorized as internal accounting controls and other internal controls. The focus of the FCPA is only on internal accounting controls, and all companies must have such controls to comply with the FCPA.

The importance given to internal controls (beyond the legally mandated internal accounting controls) can vary across organizations. The Treadway Commission [1987, 34] noted that "all other components of the overall corporate control environment, together with the internal accounting controls, comprise the internal controls" that enhance the quality of financial reporting, and RICs cover such internal controls (beyond internal accounting controls required by the FCPA) related to financial reporting.

As noted above, the Treadway Commission, POB, GAO, and AICPA have suggested that a RIC could serve as a signal of management's commitment to internal control.<sup>3</sup> Thus, a RIC could be viewed as positive news. However, empirical evidence indicates that many companies do not include a RIC in annual financial statements. The above discussion, suggesting that internal control reporting is perceived to have benefits, poses an interesting question: why are only some companies voluntarily including a RIC in their annual financial statements?<sup>4</sup>

## Litigation Risk and Reporting on Internal Control

Adler [1993, 153] noted that congress needed to take action to control securities class-action litigation because such suits had a “chilling effect ... on corporate communications.” Mednick and Peck [1994] noted that companies are reluctant to communicate information that is positive but is not required to be disclosed by securities regulations because of concerns about securities class-action litigation. Their comments may apply particularly well to the decision to issue a RIC because the issuance of a RIC, which is a signal of management's commitment to internal control, is voluntary and could be viewed as positive news.

While the inclusion of a RIC in the annual report may appear to be solely a management decision, it should be properly viewed as a joint decision of both management and the external auditor. This condition holds because, under generally accepted auditing standards, the auditor is responsible for ensuring that there is no material misstatement of other information in documents containing audited financial statements. Empirical evidence reveals that: (a) when companies are sued in securities class-action litigation, their auditors are often included as defendants [Grundfest and Perino 1997], and (b) the availability of an accounting firm as a defendant increases the likelihood of a lawsuit and the expected value of a settlement [Dunbar and Juneja 1993]. Auditors have

suggested that “even with no evidence of culpability, a company’s independent auditors are almost certain to be named in any action filed against that company” [Cook et al. 1992, 20].

### **Hypothesis Development**

Sullivan [1992] noted that because of differences in terminology related to internal control disclosures, there could be numerous situations where management issues a clean RIC although significant deficiencies exist in the control structure.<sup>5</sup> Sullivan [1992] further noted that this could lead to charges that management and auditors have misled and damaged third parties because of assertions about internal controls.<sup>6</sup> Thus, a RIC may increase the likelihood of securities class-action lawsuits against companies and their auditors [Costigan 1989; Sullivan 1992; Raghunandan and Rama 1994]. Since they may be the subject of securities class-action litigation, auditors are likely to discourage clients from including voluntary information (such as a RIC) that could increase the probability of litigation.

The above discussion suggests that the decision to include a RIC may be influenced by the perceived risk of securities class-action litigation involving the company’s auditors. Auditors may be reluctant to have companies with higher likelihoods of securities class-action litigation include a RIC in audited financial statements.

In light of the foregoing, the hypothesis, in the null form, is:

*H<sub>0</sub>: There is no association between litigation risk involving a company's auditor and the inclusion of a RIC in audited financial statements.*

### METHOD

A sample of companies was selected and their annual financial statements were examined for the presence or absence of a RIC. Logistic regression analysis was then used to examine the association between the presence or absence of a RIC and litigation risk. In the analysis, factors were selected that have been identified, both in the academic and professional literature, as being associated with the litigation risk to the auditor.

McMullen et al. [1996] and Willis [2000] note that many companies do not state anything about the effectiveness of internal controls. The inclusion of a RIC without any statement on the effectiveness of internal controls may increase the litigation risk because companies are going beyond the minimum (internal accounting control) requirements of the FCPA, and are stating that the company has other elements of internal control. In addition, the small minority of the companies which specifically include an effectiveness statement are in a different category from companies which do not have such a statement about the effectiveness of



internal controls. Hence, the sample was partitioned in to three groups: those with a RIC and effectiveness statement, those with a RIC but no effectiveness statement, and those without a RIC.

Three previous studies have directly examined factors associated with lawsuits against auditors [Carcello and Palmrose 1994; Lys and Watts 1994; Stice 1991]. A limitation of these studies, as suggested by Raghunandan and Rama [1999], is that they span a long period of time (the shortest period of the three studies is 20 years), and many professionals have noted that the environment of auditing has changed significantly in recent years. The three studies also differ with respect to measurement of variables. Client financial condition and size are the only two factors to have achieved significance at conventional levels in all three studies.<sup>7</sup>

The professional literature has consistently focused on two factors which may be associated with the risk of securities class-action litigation. First, many articles by auditors and others have noted that the risk of litigation is influenced by the company's financial condition [Craig 1992; Murray 1992; Sullivan 1992; POB 1993]. Second, business executives, audit partners, and academics have stated that high-technology companies are especially vulnerable to securities litigation [Adler 1993; Dunbar and Juneja 1993, 1994; McCracken 1993; Mednick and Peck 1994; *Business*

*Week* 1995; Yodowitz and Kolleeny 1994]. Also, SEC enforcement actions [SEC 1981, 1988a] and prior research [Kreutzfeld and Wallace 1986; Icerman and Hillison 1991] indicate that the percentage of assets in accounts receivable and inventory may influence the likelihood of errors and fraud.

In a recent experimental study, with audit partners and managers from Big 6 firms as subjects, Pratt and Stice [1994] found that the three most important publicly observable factors related to litigation risk were financial stress, industry membership, and asset concentration. Raghunandan and Rama [1999] used these three variables as proxies for litigation risk, in the context of client acceptance decisions by auditors following the resignation of the predecessor.

Based on the professional literature and prior research discussed above, three variables were used in this study to measure litigation risk: financial condition, industry membership and asset composition. Client financial condition (FINCOND) was measured using Zmijewski's [1984] model.<sup>8</sup> Based on Kasznik and Lev [1995] and Raghunandan and Rama [1999], high-tech (HITECH) was defined as companies with primary SIC codes of 283, 357, and 360-367.<sup>9</sup> The asset composition variable (ASTCOMP) measures the total proportion of assets in the form of receivables and inventory. Company size (LNSL) and audit firm size (BIG 6) were

also used as control variables, since large companies and companies audited by Big 6 auditors may be more likely to include a RIC in audited financial reports.<sup>10</sup>

Thus, the following multivariate logistic regression was used in the analysis:

$$\text{RIC} = f(\text{LNSL}, \text{FINCOND}, \text{HITECH}, \text{ASTCOMP}, \text{BIG6}) \quad (1)$$

where:

- RIC = 2 if the RIC included an effectiveness statement, 1 if there was a RIC without an effectiveness statement, 0 if there was no RIC,
- LNSL = log of annual net sales (in thousands of dollars),
- FINCOND = financial stress, as measured by Zmijewski's [1984] model,
- HITECH = 1 if in a high-tech industry, 0 otherwise,
- ASTCOMP = proportion of total assets in receivables and inventory, and
- BIG6 = 1 if the auditor was a Big 6 firm, 0 otherwise.

### Data

The NAARS database was used for sample selection and for determining the presence or absence of a RIC. The primary advantage of NAARS is that it enables a keyword search ("MGTRP") for identifying companies with a RIC. This greatly reduces the time and cost otherwise required to perform the analysis, while also ensuring that a large sample can be examined.

The 1993-94 NAARS file was used to select all manufacturing companies (two digit SIC codes between 20 and 39).<sup>11</sup> The analysis was restricted to manufacturing companies to ensure that it would not be confounded by any structural difference between manufacturing and service and merchandising industries. Relevant financial data was obtained from CD-SEC for the companies included in the analysis.

### RESULTS

**P**anel A of Table 1 provides evidence about characteristics of companies (a) with a RIC and an effectiveness statement, (b) with a RIC statement but without an effectiveness statement, and (c) without a RIC. Overall, companies with a RIC had significantly (a) higher sales, (b) lower proportion of total assets in receivables and inventory, and (c) lower likelihood of being in a risky industry. As seen in panel B of Table 1, despite the large sample size, only five of the ten correlations are significant; further, none of the coefficients is greater than .34. These results suggest that the analysis is not likely to be confounded due to high correlations.

**TABLE 1**  
**DESCRIPTIVE STATISTICS**

**Panel A: Mean Values for Selected Variables**

Variable	<u>C o m p a n i e s</u>		
	<u>With RIC And</u>	<u>With RIC But No</u>	<u>Without RIC</u>
	<u>Effectiveness</u>	<u>Effectiveness</u>	
	<u>Statement</u>	<u>Statement</u>	
	<u>(n = 38)</u>	<u>(n = 359)</u>	<u>(n = 1029)</u>
LNSL	14.20	13.65	11.44
FINCOND	0.12	0.13	0.14
ASTCOMP	0.36	0.34	0.42
HITECH	0.29 (11/38)	0.16 (58/359)	0.29 (297/1029)
BIG6 Auditor	0.97 (37/38)	0.97 (350/359)	0.85 (878/1029)

**Panel B: Correlation Matrix**

	<u>FINCOND</u>	<u>ASTCOMP</u>	<u>HITECH</u>	<u>BIG6</u>
LNSL	-.02	-.18*	-.16*	.34*
FINCOND		-.02	-.07*	.02
ASTCOMP			.05	-.09*
HITECH				.01

*Legend:*

- LNSL = Log of sales, in thousands of dollars;
- FINCOND = Financial stress, as measured by Zmijewski's (1984) model;
- ASTCOMP = Proportion of total assets in receivables and inventory;
- HITECH = 1 if in a high-tech industry (SIC codes: 283, 357, 360 through 367), 0 otherwise, and
- BIG6 = 1 if the auditor was a Big 6 firm, 0 otherwise.

Results from the logistic regression are presented in Table 2. The overall model is significant ( $\chi^2 = 384.7$ , d.f. = 5,  $p < .0001$ ). The coefficients of FINCOND, HITECH, and ASTCOMP are all negative and significant. These results indicate that RICs are less likely to be included in financial statements by companies: (a) in financial stress, (b) in the high-technology industries, and (c) with high proportions of total assets in receivables and inventory.

Companies, which are newly public, may be less likely to have well-established controls and less likely to include a RIC in audited financial reports. To ensure that the results were not driven by the presence of such companies, companies that had been in existence for less than five years were deleted from the sample. The results with this sub-sample were substantively similar to those for the entire sample, and the variables of interest continued to remain significant ( $p < .05$ ) in the regression.

Six different logistic regressions were performed by deleting the clients of each Big 6 firm one at a time. Sensitivity analysis also was performed, by deleting one risky industry at a time, from the overall sample. In such regressions, the results were substantively similar, and all the variables continued to remain significant at conventional levels. Thus, the results are not being driven by: (a) clients of any particular audit firm, or (b) companies belonging to any particular risky industry.



**TABLE 2**  
**RESULTS OF LOGISTIC REGRESSION**

Model: RIC = f(LNSL, FINCOND, HITECH, ASTCOMP, BIG6)

<u>Variable</u>	<u>Coefficient</u>	<u>Chi-square</u>	<u>p-value</u>
Intercept1	- 8.29	169.87	.000
Intercept2	-11.43	277.64	.000
LNSL	0.58	200.08	.000
FINCOND	-0.76	5.81	.015
ASTCOMP	- 1.36	8.93	.003
HITECH	- 0.30	3.22	.072
BIG6	0.79	5.00	.025

Model Chi-square = 384.7 (d.f. = 5, p < .0001); c-statistic = .81

*Legend:*

- RIC = 2 if RIC present with statement about effectiveness of internal controls, 1 if RIC present with no statement about effectiveness of internal controls, 0 if no RIC present.
- LNSL = Log of sales, in thousands of dollars.
- FINCOND = Probability of bankruptcy as measured by Zmijewski's [1984] model.
- ASTCOMP = Proportion of total assets in receivables and inventory.
- HITECH = 1 if in a high-tech industry (SIC codes: 283, 357, 360 through 367), 0 otherwise, and
- BIG6 = 1 if the auditor was a Big 6 firm, 0 otherwise.

## SUMMARY

In recent years, reporting on internal control and auditor involvement with such reports have been of considerable interest to the public accounting profession. Among others, the Treadway Commission, the GAO, the POB, and the Board of Directors of the AICPA have recommended that the SEC mandate public companies to include a management report on internal controls (RIC) in financial reports. In addition, the POB and the GAO also have suggested that auditors should be involved with RICs by expressing an opinion on such assertions on internal control.

In addition, auditors and public company executives have claimed that the threat of securities class-action litigation is associated with reduced disclosures by public companies. In this study, empirical evidence was provided about the association between the presence of a RIC in annual financial reports and factors associated with securities class-action litigation involving a company's auditors. The annual reports of a sample of manufacturing companies were examined for the presence or absence of a RIC.

The results of the analyses revealed that the likelihood of a company including a RIC in audited financial statements is inversely related to: (a) financial stress and (b) proportion of assets in



receivables and inventory. In addition, companies in high-tech industries were less likely to have a RIC. These results are consistent with claims, by auditors and others, that voluntary disclosure in the form of a RIC is inversely related to litigation risk.

#### ENDNOTES

- <sup>1</sup> The SEC, in 1979 and in 1988, attempted to mandate RICs in audited financial reports [SEC 1979, 1988b]. In the face of significant opposition from some preparers, the SEC failed in those attempts [Treadway Commission 1987; Schuetze 1993].
- <sup>2</sup> Subsequently, the Private Securities Litigation Reform Act of 1995 included specific auditing requirements for public companies. However, the provisions in the Reform Act (related to going-concern reporting and insider transactions) essentially codified existing GAAS.
- <sup>3</sup> Consistent with this view, McMullen et al. [1996] found that companies with a RIC were less likely to have had financial reporting problems.
- <sup>4</sup> One answer is that companies without a RIC perhaps have lower quality internal controls than companies with a RIC. This in turn raises the question: what prevents companies from issuing a RIC irrespective of the quality of internal controls?  
Another possible answer is that companies may believe there are no benefits associated with a RIC. However, even if this were true, it still leaves the question: why are some companies less likely to include a RIC than other companies?

- <sup>5</sup> In particular, management may use the absence of “material weaknesses” as the relevant standard for including a RIC, while auditors use the lower standard of “reportable conditions” to communicate internal control issues to management.
- <sup>6</sup> In essence, Sullivan seems to suggest that an “expectation gap” may arise in the context of RICs.
- <sup>7</sup> In two of the three prior studies examining litigation against auditors (cited above), a proxy for auditor independence (measured using ratios of a client’s sales to total sales of all public clients of an auditor) has achieved significance. There are two problems associated with this measure. First, such a measure is incomplete because it excludes data about sales by all other (non-public) clients of the auditor. Second, given the large number of clients of the Big 6 and other national firms (which dominate our sample), the range and variations of such a measure are miniscule.
- <sup>8</sup> While there are different ways to calculate the financial stress of companies, Jones [1987] notes that the predictive abilities of most models using financial statement data are substantively similar. Zmijewski’s measure (a) has recently been used by auditing researchers in many settings, (b) is free from errors related to choice-based sampling, (c) is parsimonious, requiring only three ratios, which in turn (d) leads to fewer observations being deleted because of lack of data.
- <sup>9</sup> The industries are pharmaceuticals, computers, and electronics, respectively.
- <sup>10</sup> Size has been used as a control factor and proxy for a variety of constructs by accounting and auditing researchers; as such, it is difficult to interpret any significant association for client size.
- <sup>11</sup> The 1994 file (the last file included in the NAARS library), covering the period July 1994 to June 1995, only includes 950 annual reports. The AICPA has subsequently discontinued the NAARS database. NAARS includes all NYSE and AMEX listed companies.

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