USING COMMUNICATION THEORY TO ANALYZE CORPORATE REPORTING STRATEGIES IN THE BANKING INDUSTRY

Sheri Erickson, Minnesota State University Moorhead
Marsha Weber, Minnesota State University Moorhead
Joann Segovia, Winona State University

ABSTRACT

The purpose of this study is to investigate one specific industry, banking, and its management responses to material weaknesses in internal control within its Sarbanes-Oxley Section 404 reporting. Analysis of corporate financial disclosures using communication theory can provide useful information to stakeholders.

Benoit's (1995) image restoration typology assists in the determination of the communication strategies banks use to explain how such material weaknesses occur and how management intends to address those weaknesses. Because the banking industry has historically been highly regulated, one would expect few internal control problems or weaknesses, but results of our study indicate that this is not the case. Firms within the banking industry do report material weaknesses and these firms do not consistently indicate a corrective action strategy to remediate these weaknesses. Statistical results indicate that material weakness firms display higher market risk, greater asset growth, lower risk-based capital ratios, and riskier loan portfolios than firms in the banking industry. We also provide examples from corporate SEC and annual reports of banking companies to illustrate the use of various communication strategies based on Benoit's typology.

INTRODUCTION

The problems relating to business failures early in this decade exposed manipulations of financial reporting, distortions in economic performance in the accounting for and disclosure of transactions, and lapses in corporate governance. These problems resulted in Congress establishing requirements for corporate governance through its passage of the Sarbanes-Oxley Act (SOX), which requires firms to disclose material weaknesses in internal controls for financial reporting, directs management to disclose its assessment of those internal controls, and mandates that each company's independent auditor assess the management report and the company's systems of internal control. With the enactment of SOX, the U.S. Congress acknowledged major issues relating to the quality of earnings, transparency of financial reporting, and investor confidence in financial reporting and

المنارة للاستشارات
www.manaraa.com

directed the SEC to study a principles-based accounting system (United States Congress 2002, Sarbanes-Oxley Act Section 108). The major objective of SOX is to attempt to protect investors by improving the accuracy and the reliability of corporate disclosures that increase the transparency of reporting.

Recent failures in the banking industry and investigations into possible fraudulent activity in several large, failed financial service firms may indicate that the provisions of SOX have not gone far enough to prevent serious failures in corporate governance that can result in significant financial losses. The purpose of this study is to investigate one specific industry, banking, and its management responses to material weaknesses in internal control within its Section 404 reporting. Because the banking industry has historically been highly regulated, one would expect few internal control problems or weaknesses, but results of our study indicate that this is not the case. Firms within the banking industry do report material weaknesses and these firms do not consistently indicate a corrective action strategy to remediate these weaknesses.

This study uses Benoit's (1995) image restoration theory to identify the type of communication strategies banking companies employ to inform the public about material weaknesses found in internal controls. We also provide examples of Section 404 reports to illustrate the use of Benoit's theory to analyze management's responses. By studying these responses, we can determine whether management reacts to material weaknesses with corrective action strategies or whether other strategies are used. If management uses communication strategies other than corrective action, stakeholders may have concerns about management's acceptance of its responsibility for establishing, maintaining, and reporting on the effectiveness of internal controls and whether the company will address and remedy these internal control weaknesses.

Our results include an analysis of management responses within 65 banking companies that reported a total of 97 material weaknesses in their 2005 SEC filings (10-Q and 10-K). Benoit's (1995) image restoration typology assists in the determination of the type of communication strategies management uses to explain how such material weaknesses occur and what strategies management intends to use to address those weaknesses. As anticipated, the results of the analysis show that the majority of companies use a corrective action strategy when addressing material weaknesses. However, several firms use other communication strategies that include denial, evasion of responsibility, and reducing the offensiveness of the problem. When companies use communication strategies other than corrective action, management reporting is potentially not transparent and may indicate that management is not taking full responsibility for implementing and maintaining effective internal controls.

BACKGROUND

SOX requirements relating to financial reporting and internal control analysis emphasize management responsibility for preparing financial reports. This has generated academic interest, resulting in several different research streams regarding firm reporting and compliance under

المنارة للاستشارات
www.manaraa.com

Section 404, including the market reaction to internal control weakness disclosures (Hammersley et al. 2008; Beneish et al. 2006; De Franco et al. 2005) and the characteristics of firms that report material weaknesses (Doyle et al. 2007; Ashbaugh-Skaife et al. 2007; Ge and McVay 2005; Bryan and Lilien 2005). This study concentrates on how management communicates and addresses material weaknesses by analyzing firms' Section 404 disclosures within the banking industry.

We selected the banking industry for several reasons. First, more stakeholders exist in bank governance than in non-financial types of businesses due to banks' role in promoting the stability of the economy and the liquidity function. Therefore, loss of confidence in the banking system can cause serious economic problems and stakeholders should be concerned about the quality and transparency of financial reporting (Craig 2004). Second, Rezaee and Jain (2005) and Beasley et al. (2000) cite numerous studies that find that the financial services industries have a prevalence of fraudulent financial statements even though this is a highly regulated industry. In addition, studies by Loebbecke et al. (1989) and Akhigbe and Martin (2008) reinforce the importance of strong internal controls over top management.

Finally, we selected the banking industry because it has been subject to a higher degree of internal control regulation than nearly all other industries since the passage of the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991. Under FDICIA, all U.S. banks with total assets of $500 million or more are required to file an annual report with regulators in which management attests to the effectiveness of the bank's internal controls and an independent public accountant must attest to and report on management's assertions. Though banks have been subject to FDICIA requirements since the early 1990s, lapses in internal control exist. In 2003, the Basel Committee released a paper, *Sound Practices for the Management and Supervision of Operational Risk*, which outlines a set of principles that govern the management of operational risk at depository institutions. The Committee attributes many of the bank failures in recent years to operations risk in the form of executive fraud by manipulating internal controls, lax controls of information systems, or lack of financial competence of managers and boards of directors to monitor risk exposures. Operations risk may arise from inadequate or failed internal processes, people or systems, or from external events.

Internal control weaknesses are clearly a concern in the banking industry and SOX 404 requires that management addresses internal control weaknesses in reports to stakeholders. Image restoration communication strategies can provide insight into how these weaknesses are communicated by management and how they intend to correct those weaknesses.

Communication Theory and Image Restoration Strategies

Communication is a goal-directed activity that involves a purpose. One of the central goals of communication for the corporation is to maintain a positive image (Benoit, 1995). This is reinforced by the existence of public relations departments or public relations firms hired for the purpose of making or re-making company images. A reputation may be damaged intentionally or

المنارة للاستشارات
www.manaraa.com

unintentionally through word or deed. When this happens the communicator is faced with the problem of negative public image. Benoit creates his theory based on the assumption that, due to this potential negative image, the communicator is motivated to restore its image as one of the central goals of its communication to the public.

Business communication researchers have examined narrative portions of annual reports, including the CEO letter to shareholders and management's discussion and analysis and have begun to use communication theory and image restoration research to look at how managers and corporations communicate their financial and non-financial information to the public (Hildebrandt and Snyder, 1981; Thomas, 1997; Crombie and Samujh, 1999; Jameson, 2000; Rutherford, 2005; Deumes, 2008; and Lawrence and Geppert, 2008). Accounting and finance researchers are also beginning to use communication theory models in the study of corporate disclosure of material weaknesses in internal control in Section 404 reports (Erickson et al., 2009; 2008). Erickson et al. (2009) use Benoit's image restoration typology to determine what types of communication strategies computer firms use to disclose their material weaknesses in internal control and analyze what types of material weaknesses are associated with the use of non-corrective action strategies. Erickson et al. (2008) extend their analysis to examine whether the use of non-corrective action strategies is a red flag associated with a higher likelihood of merger, bankruptcy, or other type of serious financial difficulty within the computer industry.

Benoit's Image Restoration Typology

Benoit's (1995, 1997) typology is most often used by communication researchers to analyze strategic responses to legitimacy issues. Benoit's (1995) five categories of image restoration include denial, evasion of responsibility, reducing the offensive act, taking corrective action, and mortification. These five categories include fourteen unique communication (response) strategies as shown in Table 1.

Table 1. Benoit's Typology.

Categories	Strategy	Description/example
Denial	1. Simple denial	1 Refuting outright that the organization had any part in the event
	2. Shifting the blame	2 Asserting that someone else is responsible
Evasion of responsibility	3. Scapegoating	3 Blaming the event on the provocation of another
	4. Defeasibility	4 Not knowing what to do; lacking knowledge to act properly
	5. Accident	5 Claiming the event was "accidental"
	6. Good intentions	6 Claiming the company had good intentions

www.manaraa.com

Table 1. Benoit's Typology.		
Categories	Strategy	Description/example
Reducing the offensive act	7. Image bolstering	7. Using puffery to build image
	8. Minimization	8 Stating the crisis is not bad
	9. Differentiation	9 Indicating that this crisis is different from more offensive crises
	10. Transcendence	10 Asserting good acts far outweigh the damage of this one crisis
	11. Reducing the credibility	11 Maintaining the accuser lacks credibility
	12. Compensation	12 Paying the victim; making restitution to set things to where they were before the event
Taking corrective action	13.Corrective action	13 Taking measures to prevent event from reoccurring
Mortification	14. Mortification	14. Admitting guilt and apologizing
Source: Benoit (1995)		

Denial can come in two forms. One is simple denial, or an outright refutation that the organization had any part in the event or was responsible in any way. The other type of denial is shifting the blame or asserting that someone (or something) else is responsible for the problem. Denial is the best strategy if the firm is truly blameless. If the firm uses a denial strategy and later is found to have blame in the event, its reputation can be irreparably damaged.

If denial is not an appropriate strategy, the organization can choose to evade responsibility by using one or more of four strategies. The first is scapegoating, which involves blaming the crisis on the provocation of another. Other evasion strategies include defeasibility, in which the organization did not know what to do or lacked the ability to act properly, claims the crisis was accidental or, that the organization had good intentions and therefore should be exonerated.

If a company cannot evade a responsibility that clearly exists, the company can reduce the offensiveness of the act by image bolstering (puffery), minimization (the event is not very bad), differentiation (this event was different from more offensive ones), transcendence (the good we do as an organization far outweighs the damage done by this one event), reducing the credibility of the accuser, and victim compensation. In the case of internal control weaknesses, victim compensation is not possible because no known loss has yet occurred. A lack of internal control is a warning that possible losses can occur in the future if such weaknesses are not detected and corrected in a timely manner.

Corrective action is Benoit's (1995, 1997) fourth strategy. An organization that uses this strategy tries to make amends for the wrong that was committed and takes measures to prevent the event from reoccurring. Corrective action is the most viable strategy in reporting internal control weaknesses because the firm addresses the source of the problem, explains how changes will eliminate future occurrences of the problem, and implements a remediation plan. When corrective action is used, management accepts its responsibility to maintain proper internal controls. The final

المنارة للاستشارات
www.manaraa.com

strategy proposed by Benoit is mortification, where the organization admits it was at fault and apologizes to the victims.

MANAGEMENT RESPONSE TO DISCLOSURE OF MATERIAL WEAKNESS IN INTERNAL CONTROL

As companies report their financial results, they strive to maintain a positive image and preserve legitimacy. A significant event or disclosure may result in a company trying to reduce the users' reaction to negative results. A company could also defend or restore its image to reduce the spotlight for misbehavior or wrongdoing. Thus, a company could "engage in recurrent patterns of communicative behavior designed to reduce, redress, or avoid damage to their reputation (or face or image) from perceived wrong doing" (Benoit, 1995, p.vii), a form of image restoration.

Benoit's (1995) image restoration typology assists in the determination of the communication strategies management uses. For example, SOX requires that company officers certify their responsibility for implementing adequate internal control policies and procedures. Because management is responsible for its assessment and evaluation of internal controls, we would expect management to take corrective actions when internal control weaknesses exist. However, management may use other strategies to disclose the weakness, to evaluate the weakness, or to address its responsibility to correct the weakness. Firms can use different or multiple communication strategies in explaining these weaknesses to their stakeholders.

Using Benoit's typology, one can gain insight into how a company reports internal control weaknesses under SOX 404 and assess management's responses to these weaknesses, which provides information on how the company intends to change and improve internal controls and whether it accepts responsibility for the weakness. The existence of internal control weaknesses can provide information about a potential pre-crisis situation. If the firm fails to correct the weakness, investor and creditor confidence in the firm's financial statements may be lost or the firm may even fail.

Management must first acknowledge why material weaknesses exist before they can correct them. By studying management responses, we gain insight into how serious management is about their internal control assessment and taking corrective actions to eliminate these weaknesses.

Previous research has addressed firms reporting material weaknesses in internal controls. One stream of research documents the characteristics of firms disclosing material weaknesses. Firm size is a determinant of good internal control (Ashbaugh-Skaife et al. 2007; Doyle et al. 2007; Ge and McVay 2005; and Bryan and Lilien 2005). Large firms are more likely to have more reporting processes in place and tend to have more employees and greater resources to spend on their internal control processes whereas small firms may lack sufficient resources to implement effective internal controls and may be more likely to use a non-corrective action strategy. Rapid-growth firms may outgrow their internal controls or they may dedicate a large portion of their resources to support growth rather than internal control processes (Doyle et al. 2007). Poorly performing (less profitable)

المنارة للاستشارات
www.manaraa.com

firms may not be able to invest in the proper internal control processes or they may be so concerned about improving their financial performance that they do not put sufficient resources and time into their internal controls (Ge and McVay 2005 and Ashbaugh-Skaife et al. 2007). The age of the firm may also be associated with the existence of material weaknesses as younger firms may not have the appropriate procedures in place to effectively manage their internal control processes leading to a higher likelihood of having material weaknesses and a lower likelihood of a corrective action response (Ge and McVay 2005; Doyle et al. 2007; and Ashbaugh-Skaife et al. 2007). Bryan and Lilien (2005) find that firms with higher market risk (beta) are more likely to have material weaknesses than firms with lower betas.

Another stream of research addresses types of material weaknesses firms disclose. Ge and McVay (2005) indicate that some of the most common deficiencies for banks are account reconciliation and period-end accounting policies. Deficiencies in accounting for loans (including accruals, loan loss reserves, provision for loan losses, and charge offs) may fall in both of these categories. We would expect that banks with riskier (lower quality) loan portfolios would be more likely to report material weaknesses than banks with higher quality loans. A bank's regulatory capital position may also affect its ability to respond appropriately to material weaknesses in internal control. Banks that do not meet regulatory guidelines may be concerned about improving their capital position and not devote the time and resources to improving their internal control systems.

The research has not evaluated how the firm communicates a material weaknesses and whether firms with different characteristics communicate the weaknesses differently. This discussion leads us to our first series of research questions:

RQ1: Do banking firms respond to material weaknesses with a corrective action strategy, recognize their responsibility, and take or plan to take action to correct the weaknesses?

RQ1b: How do material weakness firms in the banking industry compare to the banking industry as a whole in terms of size, profitability, age, growth, asset quality, market risk, and regulatory capital position?

Since the use of corrective action strategies implies that management acknowledges that they are responsible for the material weakness(es) and intends to make corrective changes, we are most interested in management's use of non-corrective action strategies. The use of these types of strategies could signal that management is less concerned with transparency in financial reporting and their strategic communication with the public.

Because the reporting requirements for SOX 404 are a result of Congressional action following corporate failures, the language used by firms to address material weaknesses in internal control is a relatively new type of corporate communication and firms were provided limited guidance on how to communicate this information. Firms may construct this communication in any

المنارة للاستشارات
www.manaraa.com

way they choose, so it is helpful to look at specific examples of how these messages are constructed. This discussion leads us to our second series of research questions:

RQ 2a: Do banking firms use non-corrective action strategies in SOX 404 reports to address material weakness deficiencies? If so, what are the most commonly used strategies?

RQ2b: If banking firms use non-corrective action strategies, what are specific examples of these strategies from our sample?

METHODOLOGY

This study uses a critical analysis method of studying communication strategies employed to repair tarnished images by carefully examining the language used by firms to communicate material weaknesses in internal controls and whether the company plans to correct the weakness in the future. An examination of the text of these communications provides insight into how companies use communication strategies to report these weaknesses.

Critical analysis of strategic communication has been used by many scholars, including Benoit (2006); Benoit and Czerwinski (1997); Benoit and Henson (2009); Blaney et al. (2002); Coombs (1995); Hearit (1995); and Seeger et al. (2003). A variety of texts have been evaluated using critical analysis, including speeches, advertising, newspaper articles, and public relations announcements.

We identified all firms in the banking industry (SIC Codes 6021, 6022, 6029, 6035, and 6036) that reported material weaknesses in internal control in their 2004 and 2005 10-K and 10-Q SEC filings from two sources: 1) Compliance Week and 2) EDGAR by searching the keywords "material weakness" and "internal control" and collected each firm's Section 404 report. These material weakness disclosures are made in Item 9A: Controls and Procedures of the firm's 10-K and in Management's Report on Internal Control over Financial Reporting and in Item 4: Controls and Procedures of the 10-Q.

Accelerated filers began reporting for years ending after November 2004 (2005 annual report). Thus, our data reflects the first time a firm reported an internal control weakness under Section 404.[1] If a firm reported no material weaknesses during 2005 but did indicate a correction for a material weakness stated in their voluntary reporting for the previous year, we collected the data for 2004 rather than 2005.

Two researchers, using critical analysis, read all the reports and independently classified the material weakness responses using Benoit's (1995) typology. Most firms' reports numbered the material weaknesses, followed by a corresponding number that contained the particular action the firm would take to correct the weakness. Any classification discrepancies between the two

المنارة للاستشارات
www.manaraa.com

researchers in classifying the responses according to Benoit's (1995) theory were discussed between the researchers and a consensus was reached as to the proper classification.

RESULTS

The resulting population includes 65 companies within the 773 firms in the banking industry that disclosed a total of 97 material weaknesses during the sample period. Some material weaknesses evoked more than one response, resulting in a total of 110 responses.

In response to research question 1a: Do banking firms respond to material weaknesses with a corrective action strategy, recognize their responsibility, and take or plan to take action to correct the weaknesses?, we find that management uses corrective action most frequently (97 times or 88% of the time). However, one of the most interesting observations is that some firms use image restoration communication strategies other than or in addition to the expected corrective action. The use of other strategies may provide additional insight into management's reporting that is not transparent and that management may not accept responsibility to take measures to prevent material weaknesses in the future. The use of specific non-corrective action strategies is explored further in the discussion for the second set of research questions.

In response to research question 1b, How do material weakness firms in the banking industry compare to the banking industry as a whole in terms of size, profitability, age, growth, asset quality, market risk, and regulatory capital position?, we used a univariate analysis to compare the median values of the material weakness firms and of the banking industry for firm size, profitability, growth, market risk, asset quality, and regulatory capital position. Table 2 shows the characteristics of material weakness firms (65 firms) versus the banking industry (773 firms) and the mean and median values for each variable. 2,3

Table 2: Characteristics of Material Weakness Firms versus Banking Industry 2005

	Material Weakness Firms		Banking Industry [1]		Wilcoxon Test Statistic (two-tailed) (p value)
	Mean	Median	Mean	Median	
VARIABLE					
Size	N=65		N= 773		
Total Assets (in millions)	$25,010.69	$1,775.82	$11,440.06	$848.33	0.0000***
Book Value (in millions)	$2,031.38	$147.88	$922.70	$77.52	0.0002***
Market Cap (in millions)	$3,971.85	$371.61	$1,766.19	141.46	0.0000***

المنارة للاستشارات
www.manaraa.com

Table 2: Characteristics of Material Weakness Firms versus Banking Industry 2005

Employees	3.99	0.42	2.17	0.24	0.0001***
Profitability					
ROA (%)	0.98	1.01	0.93	0.94	0.0000***
NIM (%)	3.71	3.65	3.81	3.75	0.2670
Growth					
Asset growth (2000-2005) (%)	15.79	12.76	13.20	10.40	0.0000***
Market Risk					
Beta	0.70	0.78	0.30	0.27	0.0000***
Asset Quality					
Net charge-offs/Total Assets	-0.02	-0.01	-0.01	-0.01	0.0001***
RLL/Total Assets	1.19	0.81	0.80	0.80	0.0000***
PLL/Total Assets	0.26	0.18	0.20	0.10	0.0000***
Capital position					
Total Risk-Adjusted Capital (%)	13.59	12.21	14.58	13.02	0.0194**
Tier 1 Risk-Adjusted Capital (%)	11.12	10.64	11.89	11.00	0.1540

[1] SIC Codes 6021, 6022, 6029, 6035, and 6036.
***Indicates significance at the 0.01 level
** Indicates significance at the 0.05 level
All data were gathered from Compustat except Firm Age, which was gathered from Lexis Nexis. Total Assets, Book Value (equity), and Market Capitalization (price x shares outstanding) are dollar amounts shown in millions. ROA (%) is return on assets, measured by dividing net income before extraordinary items by total assets and is used as a measure of firm profitability. Another measure of profitability, NIM (%) is found by dividing net tax equivalent interest income by average interest earning assets. Employees indicates the number of employees per firm. Asset growth is calculated by finding the average annual growth rate in assets over a 5 year period. The asset quality variables are found by dividing net charge-offs, reserve for loan losses, and provision for loan losses by total assets, respectively. Total risk-adjusted capital represents the combined core and supplementary capital ratio and tier-1 risk adjusted capital is reported by equity capital plus minority interests less portion of perpetual preferred stock and goodwill as a percent of adjusted risk-weighted assets. Beta is a measure of market risk and is calculated over a 60- month time period. Firm age (in years) is number of years the firm has price data available on Lexis Nexis.
The Wilcoxon Statistic tests the statistical significance of differences in the medians of the material weakness firms and the banking industry. Medians were used instead of means because data for most firm characteristics are skewed.

Results of our study are consistent with those of Bryan and Lilien (2005), who find that firms with material weaknesses have higher levels of market risk (as measured by beta) than non-material weakness firms. Our study finds the median beta for the material weakness firms is 0.78, which is significantly higher than the median beta for the banking industry of 0.27. We also expect that

المنارة للاستشارات
www.manaraa.com

banks that report material weaknesses will have lower risk-adjusted capital ratios than firms in the banking industry. Results of our analysis indicate that this is the case; the Total Risk-Adjusted capital ratio is lower for the material weakness firms than for the industry as a whole. Also, as we anticipate, material weakness firms exhibit higher asset growth than the median for the industry. Finally, material weakness banks have higher medians for two of the asset quality ratios (reserve for loan losses/total assets and provision for loan losses/total assets) indicating that firms with material weaknesses may have riskier loan portfolios than the banking industry as a whole.

However, we also observed several differences from previous research. First, three size variables (book value, market capitalization, and total assets) for the material weakness firms indicate that material weakness firms are larger than the median for the banking industry. Another indicator of firm size, number of employees, indicates that the material weakness firms have more employees than the median for the industry. The return on assets, a measure of profitability, indicates that material weakness firms are more profitable than banking industry firms.

In response to research question 2a, Do firms use non-corrective action strategies in SOX 404 reports to address material weakness deficiencies? If so, what are the most commonly used strategies?, we find that 11 of the material weakness banking firms use other image restoration communication strategies, resulting in 13 non-corrective action responses. This may indicate that reporting lacks transparency and that management may not accept responsibility for these weaknesses or are not taking measures to prevent material weaknesses. Table 3 presents a summary of management strategies used to respond to material weaknesses.

Table 3: Image Restoration Strategies by Typology

Typology	Number of Times Used	Total for Category
Denial:		
Denial	1	
Shifting the Blame	0	**1**
Evasion of Responsibility		
Scapegoating	7	
Defeasibility	2	
Good Intentions	2	**11**
Reducing the Offensiveness		
Bolstering Image	1	
Minimization	0	
Differentiation	0	**1**
Taking Corrective Action		**97**
TOTAL		**110**

المنارة للاستشارات
www.manaraa.com

The most prevalent non-corrective action strategy used by firms in our sample is scapegoating, an evasion of responsibility strategy indicating that management does not want to take all of the responsibility for failure to implement effective internal controls. Other strategies used by firms in our sample to a lesser degree include defeasibility, a claim of having good intentions, shifting the blame to another party, bolstering the firm's image, and denial.

To address research question 2b, If firms use non-corrective action strategies, what are specific examples of non-corrective action communication strategies from our sample?, we selected excerpts from 10-K, 10-Q, and corporate annual reports from the 13 instances in which firms used non-corrective strategies to illustrate various communication strategies managers use to respond to material weaknesses in internal control over financial reporting based on Benoit's (1995) typology. We chose these examples to illustrate several non-corrective action strategies used by firms in our sample. Table 4 contains these excerpts and an analysis of the strategies used to respond to material weaknesses in internal control.

Table 4: Excerpts from SOX 404 Communications and Classification According to Benoit's Typology

Company	Excerpt Explanation	Benoit's Typology
Bay View Capital	We were unable to assess the effectiveness of internal controls of one of BVAC's third-party service organizations. The internal control weakness is blamed on the third-party vendor	Evasion of Responsibility - Scapegoating
Main Street Banks Inc	Material weaknesses occurred due to "the inability of the company to fill accounting, treasury, and other financial related positions as many organizations were seeking similar expertise." The material weakness was blamed on inability to compete with others seeking the same type of employees and executives in the company	Evasion of Responsibility - Scapegoating
Popular, Inc.	"…our U.S. mortgage and consumer lending subsidiary, with the intent to sell in the secondary market…were incorrectly presented as cash flows related with investing activities, instead of operating activities". The firm blamed the weakness on the failure of their subsidiary to properly classify cash flows	Evasion of Responsibility - Scapegoating
Mountain Bank Holding Company	…"we had not correctly recorded the benefit obligation for our executive retirement plan. A third party vendor was providing the calculation…and the Company's review control failed to identify errors". Although the firm did admit they failed to discover the error, they place the cause of the error on the third party vendor.	Evasion of Responsibility - Scapegoating
Midwest Bank Holdings	"The determination of whether available-for-sale securities are other than-than-temporary involves substantial judgment". Also, "FASB delayed the effective date…" The firm denies it recorded valuation declines in investment securities improperly by claiming that judgment is involved and that the effective date for the accounting rule change shields them from blame.	Denial – Simple Denial

المنارة للاستشارات
www.manaraa.com

Table 4: Excerpts from SOX 404 Communications and Classification According to Benoit's Typology

Company	Excerpt Explanation	Benoit's Typology
Juniata Valley Financial Corp.	Because the Corporation was not aware until the first quarter of 2005 that the Corporation is an accelerated filer, the Corporation was not able to complete its documentation and testing of internal controls in a timely manner. The company is claiming it did not know any better – that it lacked knowledge about SOX reporting requirements	Evasion of responsibility - Defeasibility
Mid Penn Bancorp	The number of finance personnel is a factor of the size of the company and management's attempt at *maintaining an efficient structure.* Management claims that insufficient controls were simply due to trying to run the business efficiently.	Evasion of Responsibility – Good Intentions
Mid Penn Bancorp	The independent firm hired by management (to assess internal controls) did identify several control deficiencies, but did not identify any material weaknesses. Management, however, is aggregating the deficiencies and is reporting them as a material weakness. Management is claiming here that they combined less serious deficiencies into a more severe material weakness which requires reporting. By doing this, management is trying to give the impression that they are being harder on themselves than they need to be.	Reducing the Offensiveness - Bolstering
Source: Company 10-K and 10-Q reports. Data available from authors upon request.		

Although most banks used corrective action communication strategies to address material weaknesses, there were 13 instances in which firms used non-corrective strategies. Scapegoating, a form of evading responsibility, was the most commonly used non-corrective strategy. Bay View Capital used this strategy when it blamed the lack of internal control on a third party vendor. A problem with such a strategy is that the bank is ultimately responsible for work done by such third parties and therefore, scapegoating is not a viable strategy. Another example of scapegoating occurred when MainStreet Banks, Inc. attributed its material weaknesses to its inability to compete with other companies because there was a shortage of qualified financial and accounting personnel. Popular, Inc. placed responsibility on a subsidiary for failing to properly classify cash flows and Mountain Bank Holding Company also blamed a third party vendor for failing to provide the correct calculation for its executive retirement plan. A problem with using scapegoating as a means of evading responsibility is that when a company implies that the material weaknesses is in part due to the lack of diligence of another party, it indicates a lack of willingness to take full responsibility for its mistakes. This can lead stakeholders to question whether management is capable of overseeing the operations of the firm.

Mid Penn used another form of evasion of responsibility strategy, good intentions, when the firm claimed that the controls were inadequate because management was attempting to run the business efficiently. Its hope was that stakeholders would find this excuse admirable because all businesses should try to operate as efficiently as possible. Similarly, the evasion strategy of defeasibility, used by Juniata Valley Financial Corporation, is not a preferred strategy that management should use to avoid responsibility. When management attributed their inability to

www.manaraa.com

correct internal weaknesses by claiming they lacked knowledge about SOX reporting requirements they indicated they were not up to the task of managing the company.

Mid Penn also attempted to reduce the offensiveness of its internal control weaknesses by bolstering its image. The bank claimed that the firm hired by management to assess internal controls listed several deficiencies, which are less serious and need not be reported in Section 404 reports, but failed to find any material weaknesses. Mid Penn combined these deficiencies into a more serious material weakness, thereby forcing the bank to report these findings in the report to stakeholders. By doing this, the bank is claiming that it have gone above and beyond their duties for reporting weaknesses.

Midwest Bank Holdings used the communication strategy of simple denial by asserting that financial statements were not misstated due to material weaknesses because the company had in fact followed current guidelines in reporting losses on investment securities. This strategy is effective if a company is truly blameless, but financial statements readers may be confused as to why this material weakness was identified by the external auditors if the firm was in fact correct in its assessment of the accounting rules.

An analysis of communication strategies used in SEC reports provides insight into management's reactions to internal control weaknesses and its use of corrective action to avoid a potential crisis. If firms use communication strategies other than corrective action such as denial; evasion of responsibility; or reducing the problem through image bolstering, minimizing the weakness, or stating that their situation is different from other companies, management may not accept responsibility in correcting internal control weaknesses. Users of the financial statements may have concerns about whether these internal control problems could lead to more serious financial difficulties and whether management is fairly reporting the company's economic reality. If management uses similar strategies in other financial reporting disclosures, the company's transparency in reporting may be questionable.

SUMMARY

Image management is essential to corporations and other organizations. If a firm is perceived by its stakeholders to be responsible for an event it performed, ordered, encouraged, facilitated, or permitted to occur, the firm's image will be tarnished and needs to be restored. Using Benoit's (1995) typology, this study provides evidence that when management reports internal weaknesses, banks are most likely to communicate their intended corrective action to eliminate these weaknesses in the future; however, our examination reveals that, in some instances, management uses strategies other than corrective action including denial, evasion of responsibility, and reducing the offensive act.

These non-corrective communication strategies could provide important insight to the users of financial statements. Strategies other than corrective action could signal to stakeholders that management may not be willing to take responsibility for correcting problems that created the

www.manaraa.com

material weaknesses or that management is unwilling to establish and maintain disclosure controls over financial reporting as mandated by SOX. These strategies could reflect the overall control environment of the organization and provide a "red flag" of potential problems.

The statistical analysis in our study indicates that banks with material weaknesses have higher market risk and credit risk, greater asset growth, and lower risk-adjusted capital ratios than other firms in the banking industry. Results also suggest that material weakness banks are larger and more profitable than the banking industry as a whole.

FUTURE RESEARCH

Future research on the use of Benoit's (1995) typology to analyze corporate financial and non-financial disclosures could focus on several areas. First, do readers of management disclosures recognize the use of image restoration strategies? If so, do these tactics encourage a positive or negative reaction? Second, researchers could analyze whether certain combinations of image restoration strategies work more or less effectively than others. Finally, can Benoit's typology assist practitioners in designing messages during crises?

Additional research could also focus on other industries. While we focused on the banking industry, other industries could be studied to determine whether the same types of communication strategies were used to address material weaknesses. Future research could also focus on whether the communication strategies used to address material weaknesses had any relationship to whether those weaknesses were adequately addressed in future years.

Finally, in light of the current regulatory and financial issues affecting the banking and financial services industries, research can be conducted to determine what factors have caused failures and fraudulent activities, what effect the requirements of Sarbanes-Oxley have on the current situation, and how the problems can be remedied.

ENDNOTES

[1] Accelerated filers are companies with market capitalizations of at least $75 million, who have filed at least one annual report under Section 13(a) or 15(d) of the Exchange Act, and who are not eligible to file quarterly or annual reports on Forms 10-QSB or 10-KSB (SEC 2004).

[2] The distributions of these variables are highly skewed, so the Wilcoxon/Mann-Whitney Equality of Medians Test was used to compare the medians of the material weakness firms with those of the banking industry.

[3] A correlation analysis of the variables indicates high levels of correlation between variables used as proxies for the same characteristic (i.e. book value, market capitalization, and total assets are highly correlated and are all used as proxies for firm size). There are no other notable correlations between variables, including the correlation between ROA and NIM (both measures of profitability), which is 0.59.

المنارة للاستشارات
www.manaraa.com

REFERENCES

Ashbaugh-Skaife, H., D. Collins, & W. Kinney (2007). The discovery and reporting of internal control deficiencies prior to SOX-mandated audits. *Journal of Accounting and Economics,* 44 (1-2), 166-192.

Akhigbe, A. & A.D. Martin (2008). Influence of disclosure and governance on risk of US financial services firms following Sarbanes-Oxley. *Journal of Banking & Finance,* 32, 2124-2135.

Basel Committee on Banking Supervision (2003). *Sound Practices for the Management and Supervision of Operational Risk*. Basle, Switzerland: Basle Committee on Banking Supervision.

Beasley, M., J. Carcello, D. Hermanson, & P. Lapides (2000). Fraudulent financial reporting: consideration of industry traits and corporate governance mechanisms. *Accounting Horizons,* 14 (4), 441-454.

Beneish, M., M. Billings, & L. Hodder (2008). Internal control weaknesses and information uncertainty. *Accounting Review,* 83 (3), 665-703.

Benoit, W. L. (1995). *Accounts, excuses, and apologies: A theory of image restoration strategies.* Albany: State University of New York Press.

Benoit, W. L. (1997). Image repair discourse and crisis communication. *Public Relations Review, 23*(2), 177-186.

Benoit, W. L. (2006). President Bush's image repair effort on *Meet the Press:* the complexities of defeasibility. *Journal of Applied Communication Research, 34*(3), 285-306.

Benoit, W. L. & A. Czerwinski (1997). A critical analysis of USAir's image repair discourse. *Business Communication Quarterly, 60*(3), 38-57.

Benoit, W. L. & J.R. Henson (2009). President Bush's image repair discourse on Hurricane Katrina. *Public Relations Review, 35,* 40-46.

Blaney, J.R., W. L. Benoit, & L.M. Brazeal (2002). Blowout!: Firestone's image restoration campaign. *Public Relations Review, 28,* 379-392.

Bryan, S. and S. Lilien. (2005). Characteristics of firms with material weaknesses in internal control: an assessment of section 404 of Sarbanes-Oxley. Available at SSRN: http://ssrn.com/abstract=682363.

Coombs, W.T. (1995). Choosing the right words: the development of guidelines for the selection of the "appropriate" response strategies. *Management Communication Quarterly, 8,* 447-475.

Craig, V. (2004). The changing corporate governance environment: implications for the banking industry. *FDIC Banking Review,* 16 (4), 121-135.

Crombie, W. & H. Samujh (1999). Negative messages as strategic communication: A case study of a New Zealand company's annual executive letter. *Journal of Business Communication,* 36(3), 229-246.

المنارة للاستشارات
www.manaraa.com

De Franco, G., Y. Guan, & H. Lu (2005). The wealth change and redistribution effects of Sarbanes-Oxley internal control disclosures. Available for download at SSRN: http://ssrn.com/abstract=706701.

Deumes, R. (2008). Corporate risk reporting: A content analysis of narrative risk disclosures in prospectuses. *Journal of Business Communication,* 45 (2), 120-57.

Doyle, J., W. Ge, & S. McVay (2007). Determinants of weaknesses in internal control over financial reporting. *Journal of Accounting and Economics,* 44 (1-2), 166-192.

Erickson, S.E., M. Weber, J. Segovia, & D. Dudney (2009). Management Use of Image Restoration Strategies to Address SOX 404 Material Weakness, forthcoming in *Academy of Accounting and Financial Studies* Journal.

Erickson, S.E., M. Weber, J. Segovia, & D. Dudney. (2008, August). Can Section 404 material weakness communications predict mergers and SEC reporting problems? Poster session presented at the annual meeting of the American Accounting Association, Anaheim, CA.

Ge, W. & S. McVay (2005). The disclosure of material weaknesses in internal control after the Sarbanes-Oxley Act. *Accounting Horizons,* 19 (3), 137-158.

Hammersley, J., L. Myers, & C. Shakespeare (2008). Market reactions to the disclosure of internal control weaknesses and to the characteristics of those weaknesses under Section 302 of the Sarbanes-Oxley Act of 2002. *Review of Accounting Studies,* 13, 141-165.

Hearit, K. M. (1995). From "we didn't do it" to "it's not our fault": the use of apologia in public relations crises. In W. N. Elwood (Ed.), *Public relations inquiry as rhetorical criticism: Case studies of corporate discourse and social influence* (pp. 117-131). Praeger Series in Political Communication. Westport, CT: Praeger.

Hildebrandt, H. & R. Snyder (1981). The Polyanna hypothesis in business writing: initial results, suggestions for research. *Journal of Business Communication*, 18(1), 5-15.

Jameson, D. (2000). Telling the investment story: a narrative analysis of shareholder reports. *Journal of Business Communication,* 37(1), 7-38.

Lawrence, J. & J. Geppert (2008). Predicting firm reputation through content analysis of shareholders' letter. *Corporate Reputation Review*, 11 (4), 285-307.

Loebbecke, J., M. Eining, & J. Willingham (1989). Auditors' experience with material irregularities: frequency, nature, and detectability. *Auditing: A Journal of Practice & Theory*, (Fall), 1-28.

Rezaee, Z. & P.K. Jain (2005). Industry-wide effects of the Sarbanes-Oxley Act of 2002. *Journal of Forensic Accounting,* (6), 147-162.

Rutherford, B. (2005). Genre analysis of corporate annual report narratives. *Journal of Business Communication*, 42(4), 349-378.

Seeger, M. W., T.L. Sellnow, & R.R. Ulmer (2003). *Communication and Organizational Crisis.* Westport, CT: Praeger.

للاستشارات المنارة
www.manaraa.com

Thomas, J. (1997). Discourse in the marketplace: the making of meaning in annual reports. *Journal of Business Communication*, 34(1), 49-61.

United States Congress, House of Representatives, 2002, Sarbanes-Oxley Act of 2002. 107th Congress, 2d Session. Washington: GPO, 2002. Available for download at http://news.findlaw.com/hdocs/docs/gwbush/sarbaneSarbOxley072302.pdf.

المنـــارة للاستشارات

www.manaraa.com

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

المنارة للاستشارات

www.manaraa.com