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Research Report

The effect of external audits of internal control over financial reporting on financial reporting for clients of Big 4, Second-tier, and small audit firms

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ABSTRACT

The external audit of internal control over financial reporting (ICFR) is a very expensive and contentious aspect of the Sarbanes–Oxley Act (SOX). Larger public firms were first required to file a management report on and have an external audit of ICFR in 2004. Smaller public firms were first required to file a management report on ICFR in 2007 but are exempt from the audit requirement. Whereas most related prior research investigates the combined effect of management and auditor reports on financial reporting, this study examines the distinct effect of auditor reports on reporting quality. For companies audited by small auditors, we find evidence that financial reporting quality improves with an auditor report on ICFR. We find no evidence that auditor ICFR reports improve reporting quality for clients of Big 4 or Second-tier audit firms. Our study adds to the debate on the applicability of SOX Section 404 to smaller firms.

Introduction

This paper examines whether companies that comply with the external audit of internal control over financial reporting (ICFR) requirement of Section 404b of the Sarbanes–Oxley Act (SOX) issue higher quality financial statements than non-complying companies. Section 404b is an expensive and controversial aspect of SOX. This study assesses whether regulators were correct in their belief that this requirement would improve the quality of financial reporting (SEC, 2003). We also investigate whether the size of a company's auditor impacts the effect of this legislation on reporting quality.

Larger public firms were first required to file a management report (Section 404a) and have an external audit (Section 404b) on their ICFR in 2004. Smaller public firms were first required to file a management report on ICFR in 2007 but are exempt from the audit requirement. Most related prior research (Altamuro & Beatty, 2010; Bedard, 2006; Iliev, 2010; Nagy, 2010) investigates the combined effect of ICFR management and auditor reports on financial reporting quality. Dowdell, Herda, and Notbohm (2014) examine the distinct effect of *management* ICFR reports on reporting quality. Similar to Krishnan and Yu (2012), the present study examines the distinct effect of *auditor* ICFR reports, thereby contributing to the debate on the necessity of external audits of ICFR for smaller firms. External audits of ICFR remain a contentious feature of SOX. Examining whether they improve financial reporting on their own is important because the high costs of compliance should presumably be associated with some reporting benefits. Our study is especially timely in light of recent

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legislation providing for more exemptions from SOX Section 404 compliance.[1]

Our study extends Dowdell et al. (2014) by investigating the distinct effect of the audit report requirement, as opposed to the management report requirement, on financial reporting quality. Extending Krishnan and Yu (2012), we also investigate whether the size of a firm's auditor impacts the effect of this legislation. Larger auditors spend relatively more time assessing internal controls than smaller auditors in their general audit approach (Blokdijk, Drieenhuizen, Simunic, & Stein, 2006). Consequently, ICFR audits could have less of an impact on reporting quality for clients of larger auditors since these auditors were already assessing ICFR somewhat more than small auditors.

Using three accrual quality measures as proxies for financial reporting quality, we find that reporting quality improves for firms with an auditor report on ICFR – but only for firms audited by small auditors (i.e., auditors other than Big 4 or Second-tier firms). Our findings question the appropriateness of the recent Dodd–Frank Act exempting smaller firms from the audit report requirement.[2] Indeed, a much larger proportion of these non-accelerated firms are audited by small auditors relative to accelerated filers, suggesting that this group of firms could have used this legislation the most.[3]

The remainder of the paper is organized as follows. First, we summarize related research to develop our research questions. Next, we describe data used in our analyses, and present results. Finally, we offer a summary and conclusion based on our findings.

Background and research questions

Recent academic research suggests that SOX has been successful in achieving its goal of improving financial reporting. McEnroe (2007) surveyed financial officers and audit partners, finding that they perceive that SOX has been effective in reducing earnings management. Lobo and Zhou (2006) find Section 302 certifications to be negatively related to signed discretionary accruals and Cohen, Dey, and Lys (2008) find that absolute discretionary accruals dropped after the passage of SOX in 2002. Similarly, Zhou (2008) finds that firms report more conservatively and engage in less earnings management in the post-SOX period. More closely related to our study is research on the specific effect of Section 404 which we turn to next.

Bedard (2006) discovers that accelerated filers reporting effective internal control in their first Section 404 reports have a lower magnitude of unexpected total accruals and unexpected current accruals for that year relative to non-complying companies. Altamuro and Beatty (2010) report that requiring both a management report and auditor attestation on internal control effectiveness improves earnings quality for banks. Iliev (2010) finds a negative relationship between firms with management reports and external attestation on ICFR under Section 404 and signed discretionary accruals. Nagy (2010) detects that companies with both reports are less likely to issue materially misstated financial statements than companies not complying with either requirement. Finally, Holder, Karim, and Robin (2013) find that reporting quality deteriorates for non-accelerated filers pre- vs. post-SOX relative to reporting quality changes for accelerated filers. However, because accelerated filers were initially required to file a management report on ICFR (Section 404a) and have an external audit of ICFR (Section 404b) for the first time in 2004, it is uncertain whether the management report, the auditor report, or their combination is responsible for the findings reported in the studies above.[4]

We are aware of two studies that examine the distinct effect of the audit of ICFR. Audit Analytics (2009) reports that firms subject to Sections 404a and 404b file fewer restatements than firms that are subject only to Section 404a. Krishnan and Yu (2012) find abnormal revenues to be lower for firms providing both auditor and management reports compared to firms providing only a management report.[5] We extend these studies by investigating how the effects of Section 404b on financial reporting may be different for clients of auditors of varying size.

The intent of SOX was to improve reporting quality, and regulators regard effective internal control as the bedrock for high-quality financial reporting (Donaldson, 2005). External auditors identify internal control deficiencies during their testing, and the remediation of the deficiencies can lead to improvements in ICFR which result in better financial reporting (Ashbaugh-Skaife, Collins, Kinney, & Lafond, 2008). Bedard and Graham (2011) find that external auditors detect about three-fourths of internal control deficiencies through control testing, suggesting that Section 404b testing is an important source of detecting control deficiencies. The external audit requirement may also incentivize firms to ensure that their ICFR is robust and effective in the first place (standing up to auditor scrutiny). If controls are ineffective, an external audit could uncover material weaknesses which can result in a negative market reaction when disclosed (e.g., Hammersley, Myers, & Shakespeare, 2008).

However, some commentators argue that external audits of ICFR are unnecessary for smaller filers due to their simplicity (Cutler, 2006). Other provisions of SOX may be sufficient in ensuring reporting quality for these

[1] For example, the JOBS Act of 2012 provides for a slower accession into Section 404 for some companies.

[2] Smaller firms were permanently exempted from the attestation requirement by the Dodd–Frank Act (SEC, 2010).

[3] Our sample includes both accelerated filers and non-accelerated filer firm-years. An accelerated filer is defined as follows: a filer that (1) has a public float of at least $75 million, (2) has been subject to the Security and Exchange Commission's (SEC) periodic reporting requirements for at least 12 months and has filed one annual report, and (3) is not eligible to use the SEC's small business reporting forms. Of the non-accelerated filers in our sample, 56% of firm-years were audited by a small auditor. Of the accelerated filers, 7% of firm-years were audited by a small auditor.

[4] Dowdell et al. (2014) examine the distinct effect of management ICFR reports on reporting quality and find that management reports on their own (i.e., without attestation) improve financial reporting quality. They do not investigate the distinct effect of auditor ICFR reports.

[5] Krishnan and Yu (2012) use a discretionary (abnormal) revenue measure developed by Stubben (2010) as their measure of reporting quality. This proxy, which assumes earnings is managed through revenue, is an alternative to the more widely-used accrual quality measures that allow for earnings management via revenues and expenses.