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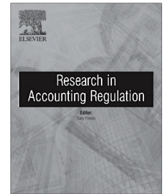

Research Report

Do management reports on internal control over financial reporting improve financial reporting?

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ABSTRACT

Sections 404a and 404b of the Sarbanes–Oxley Act require management and external auditors, respectively, to report on the adequacy of a company's internal control over financial reporting (ICFR). Larger public firms were first required to file a management report 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 attestation requirement. We investigate the distinct effect of management reports on financial reporting quality. We find that management reports on ICFR improve reporting quality and demonstrate that there are financial reporting benefits from the management report requirement on its own without attestation.

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Introduction

As a result of a sequence of high-profile accounting scandals, most notably Enron and Worldcom, the Sarbanes–Oxley Act (SOX) was passed in 2002. One of the most contentious and expensive aspects of SOX is Section 404, which requires public companies and their auditors (if a larger company) to opine on the effectiveness of the company's internal control over financial reporting (ICFR). Regulators posited that documenting and evaluating internal control would improve the quality of financial reporting (SEC, 2003).

Iliev (2010) provides evidence consistent with this, finding that the combination of Section 404 management evaluation and independent audits of internal control is associated with improved reporting quality as evidenced by lower levels of signed discretionary accruals. However, because accelerated filers (larger firms) were initially required to file a management report on ICFR (Section 404a) *and* have an external audit of ICFR (Section 404b) in 2004, it is unclear whether the management report, the auditor report, or their combination is responsible for the association between Section 404 and better financial reporting quality.[1] This is an important issue related to the question of whether companies should be required to have both a management report and an independent audit of ICFR.

Two recent papers provide evidence on the necessity of a management report and an independent audit of ICFR. Kinney and Shepardson (2011) find a significant increase in material weakness disclosures for small firms issuing initial Section 404a management reports, similar to the increase for small firms undergoing initial internal control audits. They conclude that the management report alone may provide sufficient identification of material

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[1] An accelerated filer is a company that (1) has a public float of at least $75 million, (2) has been subject to the SEC's 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.

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weaknesses. In contrast, Bedard and Graham (2011) find that auditors detect about three-fourths of internal control deficiencies, suggesting that the internal control audit is important for detecting control deficiencies. However, neither of these two papers examine whether the management report requirement (without attestation) directly affects financial reporting quality.

We examine the independent effect of the management report requirement on financial reporting quality for the period 2004 through 2010. Beginning in 2004, accelerated filers and their auditors began to report on the effectiveness of ICFR under Sections 404a and 404b, respectively. Non-accelerated filers (smaller firms) were first required to file a management report on ICFR under Section 404a in 2007 but are exempt from the Section 404b attestation requirement.[2] We compare changes in reporting quality measures across these groups to evaluate the independent effect of the management report requirement on financial reporting quality. By disentangling the effect of the management report itself (apart from ICFR audits) on reporting quality we contribute to the debate on the necessity of external audits of ICFR for smaller firms. External audits of ICFR are an expensive and controversial product of SOX. Examining whether a less costly aspect of the legislation (i.e., the management report) improves financial reporting on its own is a worthwhile endeavor. This investigation is particularly important in light of recent legislation providing for more exemptions from SOX Section 404 compliance.[3]

We find that management reports on ICFR increase financial reporting quality. Our findings indicate that the management report requirement on its own offers some reporting benefits. Our findings are consistent with Kinney and Shepardson (2011) who conclude that the management report alone (along with the financial statement audit) may be sufficient in ensuring adequate reporting quality for smaller firms. Our findings are especially important in light of the substantial costs associated with audits of ICFR that are disproportionally burdensome for smaller firms.

The remainder of the paper is organized as follows. We summarize prior research on SOX and financial reporting quality and discuss the regulatory debate on Section 404, particularly for smaller firms, to motivate our research question. Next, we describe data used in our analyses, and we present results. Finally, we offer a summary and conclusion based on our findings.

Background and research question

The intent of SOX was to improve the quality of financial reporting. Recent academic evidence indicates that the legislation has had some success in this regard. Survey evidence indicates that financial officers and audit partners perceive that SOX has been effective in reducing earnings management (McEnroe, 2007) and some archival research supports this contention (Cohen, Dey, & Lys, 2008; Lobo & Zhou, 2006; Zhou, 2008). For example, Lobo and Zhou (2006) find a negative association between Section 302 certifications and signed discretionary accruals for their sample period of 2000–2003 and Cohen et al. (2008) find that absolute discretionary accruals declined after the passage of SOX in 2002.

Iliev (2010) more specifically examines Section 404's effect (combined effect of the management and auditor ICFR reports) by comparing firms of similar market capitalization that were subject to Section 404 (accelerated filers) and firms exempt from it (non-accelerated filers) during a sample period, finding a negative relationship between full Section 404 compliance and signed discretionary accruals.[4] Krishnan and Yu (2012) examine the independent impact of the auditor ICFR report requirement by comparing accelerated and non-accelerated filers following the Section 404a management report requirement in 2007. They find abnormal revenues to be lower for firms subject to the audit requirement, concluding that Section 404b benefits accelerated filers via higher revenue quality.[5]

The costs of Section 404 (principally Section 404b) for smaller firms have been the subject of debate. The argument against Section 404 applicability for smaller firms is the disproportionately burdensome compliance costs (Nondorf, Singer, & You, 2012). Small firms do not enjoy the economies of scale that larger firms experience. Iliev (2010) estimates that non-complying small firms would have spent an additional 98% on audit fees in 2004 had they complied with the external audit requirement of Section 404b. This is in addition to internal costs (employee time and consultant fees) which typically equal or exceed ICFR audit fees (Kinney & Shepardson, 2011). Prior research finds that firms behave opportunistically to avoid SOX compliance costs. Mohan and Chen (2007), Engel, Hayes, and Wang (2007), and Leuz, Triantis, and Wang (2008) all find that firms went private or dark to avoid SOX compliance costs, and Nondorf et al. (2012) find that firms near the Section 404 compliance threshold reduced their market value temporarily during threshold measurement to avoid compliance with Section 404.

There has been less research focus on the benefits of Section 404 for smaller firms. Nondorf et al. (2012) identify one benefit of the legislation to be increased engagement from audit committees and company officers on accounting issues. Although the costs of compliance with Section 404 (chiefly Section 404b) may be disproportionally heavy for

[2] The Section 404b compliance date for non-accelerated filers was delayed several times and, in September of 2010, these smaller firms were permanently exempted from the attestation requirement with the passage of the Dodd–Frank Act (SEC, 2010).

[3] For example, the recent JOBS Act of 2012 provides for a slower accession into Section 404 for "emerging growth companies."

[4] Altamuro and Beatty (2010) investigate the financial reporting effects of comparable internal control regulation within the banking industry. The authors find that the legislation led to an improved relationship between the loan loss reserve and subsequent uncollectable accounts, increased earnings persistence and predictive value, and a lower probability of meeting or slightly beating the zero earnings growth benchmark. Similar to Iliev (2010), the authors conclude that requiring both a management report and attestation on internal control effectiveness improves earnings quality.

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

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