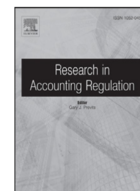
Research in Accounting Regulation 000 (2018) 1–13

Contents lists available at ScienceDirect

Research in Accounting Regulation

journal homepage: www.elsevier.com/locate/racreg



Regular Paper

The mitigation of high-growth-related accounting distortions after sarbanes-oxley

Roger C. Graham*, Jared A. Moore

Oregon State University, United States

ARTICLE INFO

Article history:
Available online xxx

ABSTRACT

This study examines the effect of the Sarbanes-Oxley Act of 2002 (SOX) on accounting distortions in the context of the earnings quality of high-growth firms relative to lower-growth firms. High-growth creates unique management and reporting challenges that can contribute to accounting-related distortions. SOX, with its emphasis on financial reporting, control systems and management responsibility, could have been particularly relevant for high-growth firms with such challenges. Test results indicate a stronger reduction (weaker increase) in accounting distortions related to total accruals and book-tax differences (performance-matched modified Jones discretionary accruals) for high-growth firms from the pre- to the post-SOX period relative to lower-growth firms. Other tests indicate that the relation between accounting returns and market returns strengthened for high-growth firms in the period after SOX, but not for lower-growth firms. These results suggest greater reductions in accounting distortions and related improvements in reporting quality for high-growth firms relative to other firms coinciding with the post-SOX period.

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Introduction

This study examines accounting distortions related to high growth and the mitigation of the distortions in the period following the Sarbanes-Oxley Act of 2002. Accounting distortions related to high growth have been documented in a number of studies. For example, Fairfield, Whisenant, and Yohn (2003) and Allen, Larson, and Sloan (2013) find less persistence in growth related accruals. Li (2014) argues that growth related accruals are less persistent because the inherent complexity of high growth makes accruals more difficult to estimate. Complexity is a natural consequence of high growth. It is not difficult to imagine that high growth can stretch a firm's business model; management must find and manage ever larger capacity. More managers and staff must be hired and trained. Cash flow planning increases in importance as growth magnifies the effect of payment cycles exceeding collection cycles. The need for additional funding must be anticipated to secure favorable financing. Pressure grows for quicker judgments and decisions (Davila & Foster, 2005, 2007). Thus, by its nature, growth can result in unintentional accounting distortions arising naturally from the increase in complexity as transactions and employees rapidly expand.

Good managerial control systems should reduce the accounting distortions associated with the increased complexity of high growth. The Public Company Accounting Oversight Board in Auditing Standards No. 2 (PCAOB 2004) notes: "The Board believes that effective controls provide the foundation for reliable financial reporting." By extension, the Board's statement implies a belief that ineffective controls are detrimental to financial reporting reliability. Others support this notion. Ashbaugh-Skaife, Collins, and Kinney (2007) argue that ineffective controls challenge a firm's information systems, thereby increasing the likelihood of intentional and unintentional misstatements. Ashbaugh-Skaife, Collins, Kinney and Lefond (2008) go a step further. They argue that control deficiencies affect managers' ability to determine reliable accrual amounts with the *unintended* consequences of noisier financial information, and deficiencies allowing managers to be opportunistic with the *intended* consequence of biased accrual estimates.[1]

It is well known that SOX created a heightened awareness on financial reporting processes. Section 302 of the Act increased

[1] Consistent with high growth increasing the likelihood of accounting distortions associated with unintentional misstatements, Gong, Li, and Xi (2009) find that management forecast errors are positively associated with high growth. Consistent with high growth increasing the likelihood of accounting distortions associated with intentional misstatements, Campbell, Hanson, Simon and Smith (2015) find that high growth is associated with meeting or beating analyst forecasts when audit committee members hold stock options.

* Corresponding author.
E-mail addresses: roger.graham@bus.oregonstate.edu (R.C. Graham), jared.moore@bus.oregonstate.edu (J.A. Moore).

https://doi.org/10.1016/j.racreg.2018.09.009
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disclosure requirements related to the effectiveness of a firm's internal controls and procedures. Section 404 of the Act requires assessment and assertions related to internal control over financial reporting. For many firms, the assessment and documentation process identified internal control deficiencies that were then reflected in auditor's opinions: one on management's assessment of internal control effectiveness and another on the effectiveness of internal control over financial reporting. Much research documents the extensive internal control weaknesses discovered and reported because of Section 404 (e.g., Bedard, Graham, Hoitash, & Hoitash, 2007, Doyle, Ge, & McVay, 2007b, Ge & McVay, 2005). Other research suggests SOX contributed to an improvement in internal controls. For example, Epps and Guthrie (2010) document a decline in adverse internal control opinions after the first and second years of SOX 404 filings. It seems reasonable to assume that if control systems were improved for all firms, post-SOX high-growth firms would have more effective control systems than high-growth firms prior to SOX.

Improvement in control systems has been linked to improvements in reporting quality.[2] Ashbaugh-Skaife, Collins, Kinney, and Lafond (2008) study firms that received internal control deficiency (adverse) opinions after the passage of SOX and that later received unqualified opinions, and vice versa. Firms moving to no reported deficiencies had modest increases in accrual quality (i.e., reduced accruals). Firms moving the opposite direction showed significant decreases in accrual quality (i.e., increased accruals). Doyle, Ge, and McVay (2007a) also find evidence linking post-SOX internal control deficiencies and reductions in accruals, at least for company-level internal controls. Neither Ashbaugh-Skaife et al. (2008) nor Doyle et al. (2007a) include specific tests for high-growth firms although both include indicators for high growth as control variables (none significant). The lack of significance for high-growth firms is puzzling, but may be addressed by exploring whether SOX may have had more of a positive impact on high-growth firms than other firms in terms of reducing accounting distortions.[3]

Whereas empirical findings are mixed (e.g., Cohen, Dey, & Lys, 2008, Lobo & Zhou, 2006, Verleun, Georgakopoulos, Sotiropoulos, & Vasileiou, 2011), anecdotal evidence supports the contention that Sections 302 and 404 improved reporting quality. When the authors asked about the effect of SOX, one international accounting firm SOX partner responded:

> "I believe that SOX overall has been very good and has been a benefit to the quality of financial reporting. I think that companies that have complied with 404 have also gotten benefit, although it is certainly debatable if it was cost effective. There is no doubt that they make fewer material mistakes now."

When the authors asked, another international firm audit partner said:

> "I think it would be a fair conclusion in general that high growth companies have improved their internal processes with the result of improved internal controls. I think it would be a very fair conclusion for any high growth company that is either an SEC registrant or intends to be in the near future; especially if their market cap is such that they are subject to SOX 404."

Initial tests are for a relation between high growth and financial statement items associated with accounting distortions with the focus on the five year periods before and after the passage of the Sarbanes-Oxley Act.[4] For each of the years in the two five year periods, the top twenty percent of firms in terms of percentage change in sales (actual growth sample) and the top twenty percent of firms in terms of market-to-book ratio (implicit growth sample) are identified. The absolute value of discretionary accruals based on a performance-matched modified Jones model, the absolute value of total accruals and the absolute value of book-tax differences serve as the variables of interest (i.e., measures of accounting distortions and inverse measures of financial reporting quality). Results indicate that the firms identified as high-growth firms have higher performance-matched discretionary accruals, total accruals and book-tax differences than do the firms identified as lower-growth firms. Tests for differences between the financial statement items reported prior to and after the passage of SOX indicate that the financial statement distortions for high-growth firms were significantly smaller after SOX. Specifically, average discretionary accruals, total accruals and book-tax differences for high-growth firms are significantly less after SOX.

Although average total accruals and book-tax differences decreased for all firms after SOX, the decrease was greater for high-growth firms than for lower-growth firms. Interestingly, average discretionary accruals for lower-growth firms increased after SOX but remained unchanged for high-growth firms. Taken together, the results support the contention that high-growth firms are most likely to experience accounting distortion (financial reporting quality) issues and that the environment following SOX improved reporting more for those firms than for others. Thus it appears that high-growth firms benefited most from the focus on reducing accounting distortions in the post Sarbanes-Oxley Act era.

Lower accruals and book-tax differences are consistent with lower accounting distortions as the financial reporting with have less error and bias. Less error and bias (and therefore higher reporting quality) will have more relevance to market participants. It follows that associations between accounting returns and market returns for high growth and lower-growth firms will be different in the periods before and after SOX. Results for the overall sample indicate that market returns increased after SOX with only a marginal corresponding increase in the overall relation between accounting returns and market returns. However, when higher-growth firms are analyzed separately from lower-growth firms, the relation between accounting and market returns only strengthened for high-growth firms (i.e., not for lower-growth firms). That the financial reporting of high-growth firms gained value relevance in the post-SOX era is consistent with fundamental improvements in the quality of high-growth firms' financial reporting.

This study makes two contributions to the literature. The first contribution relates to directly linking high growth to accounting distortions and financial reporting quality. The second contribution comes from identifying a particular group of firms most likely to

[2] The terms accounting distortion and reporting quality are used somewhat interchangeably throughout this study. The term accounting distortion may accurately describe the impact of high growth on a firm's financial reporting system. The implication of an accounting distortion is lower financial reporting quality.

[3] Many changes to the reporting environment occurred in the early 2000's that are all somewhat interrelated and all of which have improved financial reporting. For example, companies may have gotten a more conservative in their accounting after SOX but not necessarily because of improved controls. Also there have been changes to GAAP (or at least refinement based on SEC positions) as to what constitutes revenue (bill and hold, contractual arrangements, etc.) during this time frame. In addition, there have been changes (or at least refinement based on SEC positions) as to how materiality was defined. This might have had an impact on certain high growth companies. Prior to SAB 99 a company in order to meet analysts' expectations might have made an intentional immaterial "adjustment" (or not adjusted for an obvious error based on materiality) for just a few thousand dollars that could have had the effect of increasing earnings by a penny or two per share. Lastly, the provisions in SOX requiring CEO and CFO certification of financial statements likely made many executives more conservative as regards financial reporting.

[4] The context is the time period before and after the passage of SOX with its emphasis on internal controls. However, the difficulty in observing the quality of controls (Kinney, 2000, Kinney, Martin, & Shepardson, 2013) and other changes to financial reporting occurring after SOX do not allow directly connecting internal controls and earnings quality. Even so, as noted in Kinney et al. (2013), the incidence of reported internal control deficiencies has been declining since the early years after SOX was passed.

Please cite this article as: R.C. Graham, J.A. Moore, The mitigation of high-growth-related accounting distortions after sarbanes-oxley, Research in Accounting Regulation (2018), https://doi.org/10.1016/j.racreg.2018.09.009

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