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ScienceDirect

Procedia - Social and Behavioral Sciences 207 (2015) 454 – 461

Procedia
Social and Behavioral Sciences

11th International Strategic Management Conference 2015

Internal Control Weakness and Accruals Quality in Companies Listed on Tehran Stock Exchange

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Abstract

This paper investigates the relation between internal control weakness and accruals quality using data obtained from 200 companies listed on Tehran stock exchange between 2008 and 2013. We conduct correlation analysis to determine whether internal control weakness is associated with accrual quality or not. Are the internal controls designed to ensure the validity and reliability of the accounting information system and prevent deviations in identification of accruals? We estimate internal control weakness and accrual quality separately; then to test research hypothesis correlation coefficients was measured. The results indicate that accruals quality is very strongly associated with the internal control weakness and indeed, quality of accounting information (accruals) is highly dependent on both providing information environment and information resources. According to prior research in companies with high internal control weakness, will present reduced financial information quality

Peer-review under responsibility of the International Strategic Management Conference

Keywords:Accrual Quality, Internal Control Weakness, Correlation Aalysis,Information system,Reliability

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Peer-review under responsibility of the International Strategic Management Conference
doi:10.1016/j.sbspro.2015.10.115

1. Introduction

Internal control at the firm- level refer to assessing the company's financial reporting reliability and the process of evaluating achievement of company's strategic and operational goals, and assessing also the ability to act according to law and regulation. As PCAOB (**2004**) define internal control weakness is a material deficiency, or combination of material deficiencies that result in more than remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

In our country, the instruction of internal controls by Tehran Stock Exchange (TSE) –as adopted April 2012- required that the board of directors must have at least once a year to review the company's internal control system to make sure that appropriate and effectiveness internal controls is used. They must disclose the results in the statement of internal controls and evaluate whether the company's goals and objectives are attained.

In summery, the present study is looking to find out an answer to this question that whether internal control weakness is associated with accrual quality in companies listed on TSE, and does the results support and consist with the prior research in this regard or not.

Prior literature finds that the weakness of internal control is influenced by the firm characteristics (Ashbough et al, Ge.et al, Ognive). We follow Ognive et al. (**2002**) and perform multivariable cross sectional regression analysis in order to estimate probabilities of weakness of internal control in companies listed on TSE; however, the model **1** which was used in this study is different from the mentioned model because, our selected sample have no geographic or operational segment then we exclude it form the model.

2. **Literature review**

The study conducted by Dechow et al in 1995 on the identification of earnings management factors suggests that non-discretionary accruals are constant and cannot be used for smoothing. They concluded that earnings management is performed through discretionary accruals. The more there is of discretionary accruals in accruals, the more management's ability will increase to manipulate such accruals resulting in the possibility of earnings management will consequently increase. Therefore, any restriction in using none—discretionary accruals allows the financial status of the companies to be shown as better/stronger, which in turn reduces the cost of capital.

Ge and McVay (2005) found that uncovering material weaknesses positively associates with business complexity, negatively associated with firm size and negatively associated with firm profitability.

Ashbaugh-skaife et al. in their 2008 found that companies disclosing internal control weaknesses under SOX 404 typically will have lower earning quality, as measured by accrual quality and their unexpected accruals. They proposed that managers of ICD companies may be more able to override the control weaknesses and prepare accrual estimates that then facilitate meeting opportunistic financial reporting objectives.

Doyle, Ge and McVay in 2007 examined the relationship between accruals quality and internal controls for financial reporting. Their findings indicated that along with any increase of internal control weakness in companies, accruals quality will also decrease. They also pointed out that both investors and auditors highly consider the internal control environment and make use of it in their evaluations. In addition, they concluded that in those companies with high internal control weakness, management will be more likely to manipulate the accruals. And thus, these firms will have lower accruals quality.

Epps and Guthrie (2007) found that the presence of sox 404 material weaknesses has a moderate significant negative effect (income-decreasing) on discretionary accruals. However, when these accruals are stratified into high positive negative and low accruals, their overall findings indicated that the existence of material weaknesses does allow for a greater manipulation of earnings using discretionary accruals, regardless of direction-income- increasing or income-decreasing.

Doyle et al (2007) examined the determinants of weakness in the internal controls over financial reporting. They found that these firms tended to be smaller, younger, financially weaker, more complex, growing rapidly, or undergoing restructuring. Firms with more serious entity-wide control problems, however, are smaller, younger, and