Advances in Accounting, incorporating Advances in International Accounting xxx (2016) xxx–xxx

Contents lists available at ScienceDirect

Advances in Accounting, incorporating Advances in International Accounting

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

Industry contagion effects of internal control material weakness disclosures

Brian Bolton, Qin Lian, Kathleen Rupley *, Jing Zhao

Portland State University, United States

ARTICLE INFO

Article history:
Received 19 May 2016
Received in revised form 17 July 2016
Accepted 19 July 2016
Available online xxxx

Keywords:
SOX Section 404
Internal control material weakness
Industry information transfer
Share price contagion

ABSTRACT

This study examines whether there is an industry contagion effect for negative market reactions to internal control material weakness (ICMW) disclosures. From a sample of companies experiencing market share price declines to disclosures of ICMW over the years 2005–2014, results indicate that peer industry companies also experience market share price declines. We also find that the decline in share prices is related to accounting quality in that peer industry companies with higher accrual, relative to cash flow, components of earnings have larger negative market reaction compared to companies with lower accrual components of earnings. Our study contributes to the literature streams examining accounting information transfer and internal control quality.
Data availability: Data are publicly available from sources identified in the paper.

Published by Elsevier Ltd.

"*There has never been more pressure on finance leaders to ensure integrity in internal auditing and controls. Boards of directors want assurance that official financial statements are squeaky clean, with every piece of data in tables and in footnotes double-checked. There's zero tolerance for such funny business, as a business unit booking revenue in one quarter while pushing related costs to the next.*" CFO.com, April 19, 2016.

1. Introduction

Following accounting scandals including Enron in 2001 and Worldcom in 2002, the Sarbanes-Oxley Act of 2002 (SOX) was enacted to restore investor confidence by improving the integrity of reported financial information. Section 404 of SOX specifically addresses internal controls and requires the reporting of internal control material weaknesses (ICMW). Given the higher visibility and accountability related to internal controls, it is important to understand both factors associated with ICMW and costs associated with reporting ICMW. Post-SOX studies provide evidence that ICMW companies are more likely to be complex, small, financially weak, high growth, and to have undergone a restructuring (Ashbaugh-Skaife, Collins, & Kinney, 2007; Doyle, Ge, & McVay, 2007). Prior research finds ICMW impose costs on companies including negative market reaction (Hammersley, Myers, & Shakespeare, 2008), increased cost of capital (Ashbaugh-Skaife et al., 2007), shareholder dissatisfaction (Ye & Krishnan, 2007) and subsequent turnover of members of boards of directors, audit committees, and top management (Johnstone, Li, & Rupley, 2011).

This study examines whether there is an industry contagion effect for negative market reactions to internal control material weakness (ICMW) disclosures. Industry information contagion effects have been documented in numerous areas including restatements (Gleason, Jenkins, & Johnson, 2008), stock price declines (Akhigbe, Madura, & Martin, 2015), earnings management (Kedia, Koh, & Rajgopal, 2015) merger withdrawal announcements (Madura & Ngo, 2012), earnings announcements (Freeman & Tse, 1992, Ramnath, 2002), and bankruptcy filings (Ferris et al., 1997). In this study, we specifically examine whether announcement market share price declines for ICMW firms impact market share prices for companies in the same industry. From a sample of companies disclosing ICMW accompanied by announcement share price declines in the years 2005 to 2014, we empirically examine whether peer industry firms experience share price declines and whether peer industry firm abnormal returns are associated with cross-sectional differences. Consistent with our expectations, results indicate that peer industry companies also experience negative investor sentiment. Further analysis indicates the declines in share prices are related to accounting quality as peer industry companies with higher accrual components of earnings have larger negative market reaction compared to companies with lower accrual components of earnings.

When we consider the peer industry firm contagion effects over time, results indicate that the effects are time invariant and do not change across different time subsamples: the peer industry firm abnormal returns for 2007–2014 are similar to those experienced in 2005–2006. For companies with an ICMW, the probability of a peer industry

* Corresponding author.
E-mail address: rupleyk@pdx.edu (K. Rupley).

http://dx.doi.org/10.1016/j.adiac.2016.07.004
0882-6110/Published by Elsevier Ltd.

Please cite this article as: Bolton, B., et al., Industry contagion effects of internal control material weakness disclosures, *Advances in Accounting, incorporating Advances in International Accounting* (2016), http://dx.doi.org/10.1016/j.adiac.2016.07.004

ARTICLE IN PRESS

firm experiencing an ICMW within three years is negatively associated with the size of the peer industry abnormal return. That is, peer industry firms are more likely to report an ICMW within 3 years when the initial market reaction to the ICMW of another firm is more negative. This suggests that there is industry learning that takes place over time and that peer industry firms are impacted by the initial market reaction.

Our paper contributes to literature in the following ways. First, there are no studies to our knowledge documenting industry contagion effects related to ICMW. We further the industry information transfer research stream by examining industry effects in a new context — as related to internal controls. Second, we further the internal control research stream by examining another cost, the impacts to peer industry firms, imposed by the reporting of ICMWs. Third, our study provides policy makers new empirical evidence that investors use ICMW disclosures to evaluate peer industry firms. This is important as it could have implications for policy makers, including Congress, the Public Company Accounting Oversight Board (PCAOB), and industry regulators, in determining what types of information should be included in internal control disclosures.

The remainder of the paper is organized as follows. Section 2 discusses institutional background, prior research and develops the hypotheses. Section 3 discusses the sample and methods. Section 4 provides a discussion of results and the final section describes conclusions and limitations.

2. Institutional background, prior research and hypotheses development

2.1. Institutional background

The SEC adopted SOX Section 404, "Management Assessment of Internal Controls" on June 5, 2003 (SEC, 2003). SOX Section 404, effective for accelerated publicly traded firms with fiscal year-ends subsequent to November 15, 2004, requires an annual management report on internal controls over financial reporting to be filed with the SEC 10-K annual report. This report must be accompanied by an auditor attestation report by the accounting firm that audited the company's financial statements. The auditor attestation report includes both the auditor's opinion on management's assessment of internal controls over financial reporting and the auditor's opinion on the effectiveness of the company's internal control over financial reporting. Additionally, SOX Section 302 requires SEC registrants to disclose management's conclusions regarding the effectiveness of firm disclosure controls and procedures and corrective actions taken to address identified material weaknesses and significant deficiencies in quarterly and annual certifications. Prior to SOX, the only required public disclosures of internal control deficiencies occurred in SEC Form 8-K change of auditor disclosures (SEC, 1988).

As with any new audit standard or reporting regulation, how the standard or regulation is implemented and interpreted will be critical. Firms within the same industry likely utilize similar accounting practices — for example, in terms of how they account for certain accruals or how they account for sparsely traded security "mark to market" transactions (e.g. Enron). While Audit Standard 5 (PCAOB, 2007) and SOX Section 404 provides guidelines for internal control testing and reporting, how it is executed may vary across different industries. Further, there may be a learning process – by firms and by their auditors – about how to implement the new standards and regulations over time. Many industries have their own industry audit guides and accounting specific guidance in the FASB codification that may also help to explain some industry differences. Understanding relationships within industries and over time should shed light on the economic effects of any consequences of ICMW reporting. To support this notion of learning, Francis and Michas (2013) examine the effect of low-quality audits from the perspective of audit firms by studying the likelihood that the same audit firm produces other low-quality audits. They find evidence of such a contagion effect in that a low-quality audit in an office is associated with the same office producing other low-quality audits. However, this effect depends on the size of the audit firm office, and this contagion effect can disappear if the audit occurs in an industry in which the office is the industry leader. Thus, it appears intra-industry learning does take place within audit firm offices.

2.2. ICMW prior research

Prior internal control research focuses on firm factors associated with the existence and remediation of an ICMW and subsequent costs following the disclosure of an ICMW. Doyle et al. (2007) find that compared to non-ICMW firms, firms reporting ICMW are smaller, younger, more complex (with a greater number of segments), financially weak, have higher growth and more likely to have undergone a restructuring. Ashbaugh-Skaife et al. (2007) find ICMW firms have more complex operations and are more likely to have: 1) undergone a recent organization structure change, and 2) had a recent auditor resignation. Chen, Eshleman, and Soileau (2016) find firms with greater numbers of females represented on the board of directors are less likely to have ICMW. Lenard, Petrusk, Alam, and Yu (2016) find that ICMW firms have higher levels of real activity manipulation by altering operations to get higher short-term income and cash flow at the expense of future income.

Johnstone et al. (2011) examine characteristics associated with companies remediating ICMW revealing that improvements in audits committee influence, competence and incentives are associated with ICMW remediation. Li, Sun, and Ettredge (2010) find that improvements in CFO accounting and work experience are associated with ICMW remediation. He and Thornton (2013) study the relationship between ICMW disclosure and perceived earnings quality and find that there is no effect on investors' perception of earnings quality upon the initial disclosure and that the perception improves when the ICMW firm remediates their previously disclosed ICMWs.

Findings in prior literature on costs imposed on companies from ICMW disclosures include decreased stock price (De Franco, Guan, & Lu, 2005; Gupta & Nayar, 2007; Hammersley et al., 2008), increased cost of equity (Ashbaugh-Skaife, Collins, Kinney, & LaFond, 2009), subsequent turnover of members of boards of directors, audit committees and top management (Johnstone et al., 2011), higher audit fees (Raghunandan & Rama, 2006), auditor realignments (Ettredge, Heintz, Li, & Scholz, 2011) and shareholder dissatisfaction (Ye & Krishnan, 2007). Hoitash, Hoitash, and Johnstone (2012) study CFO compensation and find that, generally, ICMW disclosure leads to decreased CFO compensation. Their results indicate that the association between ICMW disclosure and CFO compensation is most pronounced at firms with strong corporate governance and at firms with greater expected costs of misreporting (such as those with a greater analyst following or those in more litigious industries). Feng, Li, and McVay (2009) provide evidence that firms that disclosing ICMWs also provide less accurate financial statement guidance and these inaccuracies are largest when the ICMW is related to revenues or costs of goods sold. Brown and Lim (2012) find a weaker relationship between earnings and executive compensation for ICMW companies as compared to non-ICMW companies. Taken together, these studies indicate that market participants view disclosures of ICMW negatively and constantly incorporate ICMW disclosure information into their analyses of other firm attributes.

2.3. Industry information transfer prior research

Considerable research has studied industry contagion effects in a wide variety of situations. Studying more than 2000 restatements from 1997 to 2008, Kedia et al. (2015) find that firms are more likely to begin managing earnings after a rival firm within their industry publicly announces a restatement; however, this effect disappears if the

Download English Version:

https://daneshyari.com/en/article/7340007

Download Persian Version:

https://daneshyari.com/article/7340007

Daneshyari.com