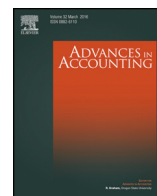




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# Internal control weaknesses and evidence of real activities manipulation

Mary Jane Lenard<sup>a,\*</sup>, Karin A. Petruska<sup>b</sup>, Pervaiz Alam<sup>c</sup>, Bing Yu<sup>a</sup><sup>a</sup> School of Business, Meredith College, 3800 Hillsborough St., Raleigh, NC 27607, United States<sup>b</sup> Lariccia School of Accounting & Finance, Williamson College of Business Administration, Youngstown State University, One University Plaza, Youngstown, OH 44555, United States<sup>c</sup> College of Business Administration, Kent State University, Kent, OH 44242, United States

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## ABSTRACT

We examine whether US public firms that file internal control weakness (ICW) disclosure reports with the Securities and Exchange Commission, as part of the reporting requirements under Section 404 of the Sarbanes–Oxley (SOX) Act, exhibit higher levels of real activities manipulation (RM), compared to firms that do not file such reports. Using firm-level data for the post-SOX period, 2004–2010, we find a positive relationship between firms reporting internal control weaknesses and real activities manipulation. Further, those ICW-firms that use RM to beat earnings benchmarks have lower performance in the subsequent year. Our results also show that firms do not use discretionary accruals as a substitute for RM when they report internal control weaknesses. Overall, our findings suggest that ICW-firms are prone to using real activities manipulation as a form of earnings management. Our findings also have implications for audit quality as auditors need to gain a better understanding of how real activities manipulation influences the operations of the firm.

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## 1. Introduction

The purpose of this study is to examine whether US firms that file internal control weakness (ICW) disclosure reports with the Securities and Exchange Commission (SEC), as part of the annual reporting requirements of Section 404 of the Sarbanes–Oxley (SOX) Act of 2002, also exhibit higher levels of real activities manipulation (RM). The extent to which ICW-firms manage earnings in the context of these operational activities has received limited attention. Provisions of Section 404 of the SOX Act require that both the management and the firm's external auditors assess the adequacy of internal controls over financial reporting (ICFR).<sup>1</sup> Although firms are required to report deficiencies in their internal controls, and external auditors are expected to issue an attestation report on the quality of internal controls of their client company, a weak system of internal controls may also influence managements' attempts to further manipulate firm operations through controlled revenues, discretionary expenses, and production costs.

Studies have generally modeled earnings management as the magnitude or level of a firm's accruals. Schipper (1989, 92) refers to "real" earnings management and states that it is "accomplished by

timing investment or financing decisions to alter reported earnings or some subset of it." Thus, while real activities transactions involve cost-cutting measures,<sup>2</sup> what differentiates them from ordinary reductions in costs is the extent to which these activities deviate, in a purely opportunistic sense, from normal business operations, and the extent to which they act merely as a short-term solution to a long-term valuation problem. Similarly, Gunny (2010, 855) states that "...managers undertake actions that change the timing or structure of an operation, investment, and/or financing transaction in an effort to influence the output of the accounting system." Contemporaneous research has shown that management uses or even substitutes accruals in favor of real activities transactions such that firm performance is either sustained or realized. For example, Chan, Chen, Chen, and Yu (2015) indicate that firms that adopt "clawbacks", or compensation recovery policies, substitute real activities manipulation for accruals management. While clawbacks have been shown to reduce financial misreporting, their study reports that earnings quality does not effectively improve because the increased use of real activities manipulation is undertaken to attract less inquiry from auditors and regulators. McGuire, Omer, and Sharp (2012) find that, although firms with strong religious social norms exhibit less financial reporting irregularities, managers of these firms still favor real activities manipulation beyond accruals management. Additionally,

\* Corresponding author.

E-mail addresses: [lenardmj@meredith.edu](mailto:lenardmj@meredith.edu) (M.J. Lenard), [kapetruska@ysu.edu](mailto:kapetruska@ysu.edu) (K.A. Petruska), [palam@kent.edu](mailto:palam@kent.edu) (P. Alam), [yubing@meredith.edu](mailto:yubing@meredith.edu) (B. Yu).

<sup>1</sup> Final compliance dates for management and auditor attestation reports issued on the effectiveness of a firm's internal control over financial reporting (ICFR) under Section 404 of the SOX Act became effective for US firms for fiscal years ending on or after November 15, 2004 for large and accelerated filers (GAO, 2013). SOX Section 302 became effective for fiscal years on or after 2002. Section 302 requires firms' CEOs and CFOs to certify, as part of the financial statements, the effectiveness of their internal controls.

<sup>2</sup> Examples of real activities management (RM) used by firms to increase earnings can include accruing a smaller amount of bad debt expense or factoring accounts receivable. Firms may postpone or eliminate research, development and maintenance costs, reduce travel budgets, or delay or cancel projects such as IT software or hardware spending. Sales can also be escalated by encouraging customers to increase order quantities in response to upcoming sales price increases.

not only does the preference for real activities manipulation occur in for-profit firms, but research provides evidence that it also exists in not-for-profit firms. For example, Eldenburg, Gunny, Hee, and Soderstrom (2011) find that not-for-profit firms control expenditures and incentive compensation with real activities in order to manage net operating income toward zero benchmarks. Brown, Chen, and Kim (2015) show that firms engage in earnings management through real activities to influence their credit ratings upward as they approach the speculative-grade categorization, or rather, sub-optimal investment ratings.

Prior research has provided evidence that firms with internal control deficiencies are associated with earnings management. Chan, Farrell, and Lee (2008) find that, for firms reporting material internal control weaknesses, there are higher incidences of both positive and absolute discretionary accruals, compared to firms that do not report material internal control weaknesses. Support for our argument for the relation between internal control weaknesses and real activities manipulation is provided by cues from several studies. Internal control weaknesses have been defined by problems associated with incorrect recognition of revenue, lack of segregation of duties, timing problems surrounding end of period reporting, and noncompliance of accounting policies (Ge & McVay, 2005), especially in regard to inventory, fair valuation of investments, and pension plans (PCAOB, 2007). Ge and McVay (2005) report that companies disclose at least one material weakness in internal controls in their annual SEC filings even after SOX became effective. They find that firms that disclose ICWs often experience problems with certain asset and earnings accounts and material weaknesses are positively associated with business complexity, and negatively associated with firm size and profitability (computed as return on assets).<sup>3</sup> Poor internal controls are associated with lower levels of accounting conservatism (Goh & Li, 2011) and poor accruals quality (Ashbaugh-Skaife, Collins, Kinney, & LaFond, 2007; Doyle et al., 2007a). Feng, Li, and McVay (2009) report that material weaknesses in internal controls affect the accuracy of management guidance.

Moreover, Ge and McVay (2005) show that high frequencies of material ICWs, classified by deficiency type, exist for the following categories: account specific, period-end accounting/accounting policies, and senior management. A study by the SEC (2011) also identifies high incidences of material ICWs which include: non-routine transaction control issues, accounting documentation, policy and/or procedures, and material and/or numerous auditor/year-end adjustments. These “planned” actions allude to the possibility that managing real activities may be an underlying characteristic of ICWs and is an important issue that requires further understanding and investigation.

The ability of auditors to investigate internal control weaknesses and real activities manipulation is a motivation for our study. Real activities manipulation is an alternate form of managerial opportunism that may be subject to less auditor scrutiny because it is obfuscated in a firm's operating decisions, instead of more clearly defined in accounting methods. Kim and Park (2014) show that since auditors cannot control clients' real activities, the audit firm tends to resign from engagements due to increased litigation risk. Their findings also indicate that, as a result of the auditor switch, firms who subsequently retain non-Big-4 auditors exhibit an even more pronounced incidence of real activities manipulation. When considering the audit of internal controls, regulators have recently questioned whether auditors even have the appropriate experience to evaluate material weaknesses in internal controls (PCAOB, 2013). Munsif, Raghunandan, Rama, and Singhvi (2011) indicate that firms pay higher audit fee premiums for at least four years after they remediate internal control weaknesses, in spite of reporting higher quality accruals.

Our study links together the literature on real activities manipulation (Cohen & Zarowin, 2010; Gunny, 2010; Roychowdhury, 2006;

Zang, 2012) and research on internal control weaknesses and financial reporting quality (Ashbaugh-Skaife et al., 2007; Ge & McVay, 2005; Goh & Li, 2011; Schipper & Vincent, 2003). Taken together, our study extends the body of literature on earnings quality by examining whether firms that report internal control weaknesses also employ real activities manipulation. Using a sample of firms for the period 2004–2010, we focus on whether firms with ICWs, compared to those without ICWs, are more apt to use RM as evidenced by abnormal levels of firm operational activities. However, our analysis reveals that those ICW-firms that use RM to beat earnings benchmarks experience negative performance in the subsequent year. We further account for the potential for self-selection bias and the endogenous nature of our variables in our primary tests. Our results are consistent with the relation of weaker internal controls resulting in greater information risk that aids in facilitating RM. That is, we observe a positive relationship between firms with ICWs and managements' propensity to use RM.

This study is organized as follows. In the next section, we discuss the background of the Sarbanes–Oxley (SOX) Act, describe financial reporting risk as influenced by real earnings manipulation, and develop our hypotheses of the expected link between internal control weaknesses and real activities manipulation. The third section describes our sample, estimation models, and variables. The fourth section presents our empirical results. In Section 5, we undertake several additional robustness tests. The final section presents the summary, conclusion, and suggestions for future research.

## 2. Literature review and hypothesis development

### 2.1. The Sarbanes–Oxley Act (SOX) and financial reporting quality

The Sarbanes–Oxley (SOX) Act of 2002 was enacted as a direct result of the more well-known and publicized accounting scandals that swept the USA in the late 1990s. The SOX Act addresses corporate governance and accountability by attempting to improve the quality and transparency of financial reporting. Section 404 of the SOX Act specifically details the detection and mandatory reporting of material weaknesses in internal controls. These corporate controls have been instituted to enforce and control firms from committing fraud. Section 302 of the Act also requires firms' managers to certify and disclose these material weaknesses in their financial reports (Beneish, Billings, & Hodder, 2008). Due to the passage of the SOX Act, information asymmetry has been posited to be reduced as firms are required to provide more transparency in their financial disclosures.

However, contemporaneous research has provided mixed findings on whether accounting quality has improved following required disclosures afforded by the SOX Act. On the one hand, due to the enhanced reporting requirements, many studies have shown that Section 404 has met its objectives and has provided benefits. For example, Nagy (2010) indicates that companies that comply with SOX Section 404 are least likely to issue misstated financial statements as evidenced by accounting restatements. Another beneficial consequence of the SOX Act is a perceived higher level of quality financial reporting, which ultimately maps into a lower cost of equity capital through a reduction in information risk.

On the other hand, opponents have stated that Section 404 has provided challenges consisting of high compliance costs and problems related to audit effectiveness. Studies have also found conflicting results as to whether firms with ICWs pay higher risk premiums. Ashbaugh-Skaife, Collins, Kinney, and LaFond (2009) and Beneish et al. (2008) examine the effect of SOX internal control deficiencies on firm risk and cost of equity. They note that disclosures made under SOX section 404 are indicative of poor quality accounting information, whether as a result of intentional or unintentional misstatements, and they document an increased cost of equity for ICW-firms. Ogneva, Subramanyam, and Raghunandan (2007) find that firms with ICWs exhibit a higher cost of equity capital compared to a control sample.

<sup>3</sup> Accounts most commonly affected by ICWs include current accrual accounts such as accounts receivable, inventory, and income taxes (Doyle, Ge, & McVay, 2007a).

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