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Voluntary Disclosure of Internal Control Weakness and Earnings Quality: Evidence From China

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ABSTRACT

Using a sample of 1059 listed firms that voluntarily provide internal control reports in the period 2010–2011, this paper investigates the relationship between voluntary disclosure of internal control weaknesses (ICWs) and earnings quality in China. Our results show that earnings quality, measured by absolute discretionary accruals, is significantly associated with voluntary disclosure of ICWs. Furthermore, our results demonstrate that both accounting-related and non-accounting-related ICWs affect earnings quality. This study contributes to the internal control literature by extending the evidence for ICW disclosure to an emerging economy and examining the impact of disclosure of different types of ICWs on earnings quality. This study demonstrates that the control of non-accounting-related ICWs is critical for enterprise risk management.

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1. Introduction

Establishing a high-quality internal control system has long been viewed as an important mechanism to ensure high-quality financial reporting. Prior studies show that weak internal control can increase the probability of material errors and false financial disclosures (Bell & Carcello, 2000; Kinney & McDaniel, 1989); it can also increase the probability of a firm restating its earnings (Bizarro, Boudreaux, & Garcia, 2011), as weak internal control creates more opportunities for intentional earnings management and unintentional accounting estimation errors (Ashbaugh-Skaife, Collins, Kinney, & LaFond, 2009; Doyle, Ge, & McVay, 2007). In July 2002, the U.S. Congress passed the Sarbanes–Oxley Act (SOX) in response to numerous corporate failures and accounting scandals (Altamuro & Beatty, 2010). The most important aspect of SOX is its requirement of the management and the auditor to evaluate internal control on financial reporting (Public Company Accounting Oversight Board [PCAOB], 2004; Securities and Exchange Commission [SEC], 2003). While the effectiveness of such regulation on internal control is still debated and remains controversial (Bedard, 2011; Costello & Wittenberg-Moerman, 2011; Doyle et al., 2007; Rice & Weber, 2012), some countries have followed the U.S. lead, introducing internal control reporting (ICR) with a softer approach (Cox, 2006). For example, Japan has implemented an internal reporting system with less strict requirements for all listed firms from 2008 (Nishizaki, Takano, & Takeda, 2014). Other countries, such as the UK and other European Union member states, have adopted a broad approach (Deumes & Knechel, 2008) that encompasses a wider scope of internal control systems in relation to the whole management

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process, rather than focusing only on financial reporting. In May 2008, the *Basic Standard of Enterprise Internal Control* (*Basic Standard* hereafter) was jointly issued by five regulatory authorities in China, including the Ministry of Finance (MOF, 2008), the China Securities and Regulatory Commission (CSRC), the National Auditing Office (NAO), the China Banking Regulatory Commission (CBRC), and the China Insurance Regulatory Commission (CIRC). Three supporting guidelines for implementing the *Basic Standard* were further issued in 2010. The *Basic Standard* and guidelines require Chinese listed firms to provide a management evaluation report on the effectiveness of their internal control as well as an auditor's assessment of the effectiveness of clients' internal control. In an ICR, the Chinese listed firm needs to disclose whether an internal control weakness (ICW) is minor, major, or serious; the ICR also includes a remedial plan for its ICWs. However, these regulations became mandatory only from January 1, 2012. Prior to this date, firms could choose to voluntarily comply with internal control regulations (MOF, 2010a,b,c).

Prior studies suggest a consistent and negative relationship between disclosure of ICWs and earnings quality in Western countries (Ashbaugh-Skaife, Collins, Kinney, & LaFond, 2008; Chan, Farrell, & Lee, 2008; Doyle et al., 2007; Lu, Richardson, & Salterio, 2011). Our study differs from prior studies in several aspects. First, China has a different financial reporting environment in comparison with Western countries. Chinese listed firms exhibit a strong presence of state ownership, heavy political influence, and weak corporate governance mechanisms (Chen & Yuan, 2004; Liu & Lu, 2007; Liu & Sun, 2005). Therefore, research findings for Western markets may not necessarily be applicable to the implementation of the *Basic Standard* in China. Second, in the United States, SOX focuses particularly on the internal control system related to financial reporting; China's *Basic Standard* is, however, more comprehensive and extends the scope of the internal control system to a much broader scope of business management. The *Internal Control Application Guidelines* identify 18 internal control areas that listed firms in China must strengthen, from organizational structure, human resource management, budget, and corporate social responsibility to procurement and sales activities, outsourcing, and contract management. Internal control directly related to the preparation of financial reporting is only one of the components of the overall internal control system articulated in the *Basic Standard*. It is therefore important to investigate the association between earnings quality and ICWs in relation to the broader internal control system in China, in contrast to the narrow disclosure scope of ICWs in the U.S. In our study, we partition all ICWs into two categories: accounting-related ICWs versus non-accounting-related ICWs. We then examine the association between earnings quality and voluntary disclosure of each category of ICW. Third, U.S. SOX-focused studies are conducted in a mandatory disclosure regime, while the institutional setting of this study is voluntary. Fourth, we investigate not only the impact of the existence of ICWs on earnings quality but also the impact of the severity of ICWs on earnings quality. Our research is a significant extension of earlier studies. Doyle et al. (2007) and Ashbaugh-Skaife et al. (2008) use a dummy variable to measure whether a firm has ICWs and then compare the earnings quality between firms with and without ICWs, whereas, Lu et al. (2011) examine the relationship between accrual quality and the number of ICWs disclosed. We use both a dummy variable and a continuous variable to measure the existence and the severity of ICWs. Then, we investigate whether earnings quality is significantly different between firms with and without ICWs, and whether the severity of ICWs affects earnings quality.

This study has two goals. First, to investigate the relationship between voluntary disclosure of ICWs and earnings quality in Chinese listed firms in the period 2010–2011, the period in which listed firms could voluntarily release ICRs.¹ Second, this study investigates whether a much broader internal control standard, which extends from accounting-related to non-accounting-related internal control, has any impact on earnings quality. We hand-collected the ICW data from 1059 Chinese listed firms that voluntarily provided ICRs in 2010 and 2011. Following prior studies (Ashbaugh-Skaife et al., 2008; Chan et al., 2008; Doyle et al., 2007), we use absolute discretionary accruals (ABSDA) as a measure of earnings quality.

Our results show that earnings quality is significantly associated with ICWs disclosed by Chinese listed firms. ABSDA is positively related to disclosure of ICWs, meaning that firms with ICWs are more likely to be engaged in earnings management through use of discretionary accruals. With respect to different types of weaknesses, our results demonstrate that earnings quality is significantly associated with disclosure of both accounting-related and non-accounting-related ICWs.

In summary, we find that voluntary disclosure of ICWs by Chinese listed firms provides additional and useful information to users, enabling them to reassess their economic decisions. Our study makes significant contributions to the existing literature on internal control as well as earnings quality and holds practical implications for policy-making in China and around the world. First, prior studies show a negative association between disclosure of ICWs and earnings quality in the SOX 302 and 404 regimes (Ashbaugh-Skaife et al., 2008; Chan et al., 2008; Doyle et al., 2007). These results, however, are limited only to the context of the internal control system with particular emphasis on financial reporting. It is not clear whether ICWs other than those in financial reporting have any impact on earnings quality. Given that financial reporting is an integrated component of business operations and that the quality of financial disclosure is affected by all aspects of business management, our results suggest that a wider scope of disclosure of ICWs, including both accounting-related and non-accounting-related ICWs, does affect earnings quality. This is consistent with the view that different elements of internal control need to function together in order to minimize enterprise risks. This finding has profound policy implications for regulators worldwide who are considering whether the SOX requirement should be expanded to non-accounting-related areas. Second, our study is the first in the internal control literature to investigate the relationship between the severity of ICWs disclosed and earnings quality in an emerging stock market, which has different institutional attributes from those in developed markets. Our results enrich the internal control literature by

¹ Li, Tian, and Qi (2012) examine the relationship between auditor's unqualified opinions on internal controls (ARIC) and accrual quality. They use the overall auditor assessment of effectiveness of internal control (dummy variable) but not the presence of ICWs as a testing variable. They did not detect a significant difference in terms of earnings quality between ARIC and non-ARIC firms. Our paper is the first to directly investigate the impact of voluntary disclosure of ICWs on earnings quality in the Chinese context.

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