Does Audit Quality Influence the Relation between Earnings Management and Internal Control Weakness in the Post–SOX Period

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ABSTRACT

Material weaknesses in the internal control system of a company create more opportunities for managers to engage in opportunistic earnings management. In this study the authors investigate the relation between earnings management and disclosed material weaknesses in the internal controls, both under SOX 302 and SOX 404, and examine whether audit quality, measured as being audited by a Big Four auditor, has an effect on that relation. The results suggest that material weakness firms have more absolute discretionary accruals and greater income-decreasing discretionary accruals. So evidence is provided that material weakness firms engage in more earnings management, however not in opportunistic income-increasing earnings management. When audit quality is high, measured as being audited by a Big Four auditor, the disclosed material weaknesses are lower just as total and absolute discretionary accruals are. It is also interesting in our findings that when material weakness firms are audited by a Big Four auditor a positive relationship seems to exist with discretionary accruals, suggesting that when a firm is audited by a Big Four auditor, material weaknesses in the internal controls will lead to opportunistic earnings management.

Keywords: Audit Quality, Big Four Auditor, Discretionary Accruals, Earnings Management, Material Weakness

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INTRODUCTION

Several United States (U.S.) financial reporting scandals jeopardized the public's faith in the U.S. capital markets, with Enron as the most known case (Bédard, 2006). Already in the 1980s the existence of fraud and unexpected business failures led to questions among the adequacy of the financial reporting system and especially the internal controls of public companies (Ge & McVay, 2005). Corporate controls are the first line of defense against misstatements in the financial statements. Auditors provide another layer of investor protection by reducing the risk of misstatements (Hoitash et al., 2008). The public is concerned that earnings management erodes the quality of financial reporting and the Securities and Exchange Commission (SEC) questioned the role of the auditor in this issue (Heninger, 2001). A higher audit quality usually will lead to less earnings management, since it limits the discretion that management can use to manage earnings in the financial statements (Becker et al., 1998). Yet Beneish et al., (2005) argued that the direction of this causality between audit quality and earnings management is not clear, since firms with high quality financial reporting may choose for high quality auditors. On the other hand, high quality auditors are more able to detect manipulations and their actions result in higher earnings quality.

Internal control weaknesses increase the risk of intended and unintended misstatements in the financial reports. Therefore it is assumed that this will increase the possibility of earnings management. For example, when there is an inadequate separation of duties, there is less control over the actions of employees and managers, so management has more opportunities to engage in earnings management. Auditing can be helpful in mitigating this problem, depending on the quality of the audit. First of all, high audit quality is expected to decrease earnings management, since high quality auditors are more likely to detect and reveal earnings management. This is due to their expertise, strictness and the fact that they have more to lose, such as reputation, when there are misstatements in the financial reports. Secondly, high quality auditors provide a better opinion on internal control, since it is expected that they are more likely to detect weaknesses in internal controls due to sufficient substantive testing. An auditor can provide an adverse opinion on the internal controls, yet provide an unqualified opinion on the financial statements as a whole. So this means that an auditor provides a reasonable assurance to the public that the financial statements are presented fairly, even though there are material weaknesses in internal controls. Since these internal control weaknesses can lead to opportunistic earnings management, it is interesting to investigate the role of audit quality on this relation. In this study we explore the effect of audit quality, with auditor size as a proxy for quality, on the relation between internal control and earnings management specifically we examine to what extent the relationship between material weaknesses in the internal control and earnings management is affected by high audit quality.

Answering this research question still makes an important contribution. Academic research remains inconclusive and earnings management remains a popular topic of debate and discussion among investors, regulators, analysts and the public (Krishnan, 2003). Researchers have tried to understand why managers manipulate earnings, how they do so, and what the consequences are (McNichols, 2000). As Scott (1997) argues an understanding of earnings management is important to auditors, because it enables an improved understanding of the usefulness of net income, both for reporting to investors and for contracting. This understanding of usefulness of net income is also of importance for investors, in order to know how much they can rely on net income to base their investment decisions on.

Since SOX was introduced to increase the independence and quality of auditors and internal controls, it is relevant to investigate the relation between audit quality, internal control and earnings management after SOX was implemented. This makes a societal con-
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