AUDITOR INDEPENDENCE, AUDIT COMMITTEE QUALITY AND INTERNAL CONTROL WEAKNESSES

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Abstract: In this paper we investigate the relation between auditor independence, audit committee quality and the disclosure of internal control weaknesses. We begin with a sample of firms with internal control weaknesses and, based on industry, size, and performance, match these firms to a sample of control firms without internal control weaknesses. Our conditional logit analyses indicate that a relation exists between audit committee quality, auditor independence, and internal control weaknesses. Firms are more likely to be identified with an internal control weakness, if their audit committees have less financial expertise or, more specifically, have less accounting financial expertise and non-accounting financial expertise. They are also more likely to be identified with an internal control weakness, if their auditors are more independent. In addition, firms with recent auditor changes are more likely to have internal control weaknesses.

Keywords: internal control weakness; audit committee financial expertise; auditor independence.

1. Introduction

Firms are more likely to be identified with an internal control weakness, if their audit committees have less financial expertise or, more specifically, have less accounting financial expertise and non-accounting financial expertise. They are also more likely to be identified with an internal control weakness, if their auditors are more independent. In addition, firms with recent auditor changes are more likely to have internal control weaknesses.

Independent audit committees and audit committees with more financial expertise are significantly less likely to be associated with the incidence of internal control problems. Material weaknesses in internal control are more likely for firms that are smaller, less profitable, more complex, growing rapidly, or undergoing restructuring. Firms with more complex operations, recent changes in organization structure, auditor resignation in the previous year, more accounting risk exposure, and less investment in internal control systems are more likely to disclose internal control deficiencies. In addition, we document that auditor independence is an important determinant of internal control weaknesses.

2. Background and hypotheses

2.1. Background

Internal control is defined as a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives, according to the COSO framework[1]. Management must disclose significant internal control deficiencies, when they certify annual financial statements. Specifically, the signing officers, being responsible for internal controls, have evaluated the internal controls and reported in their findings: (1) a list of all deficiencies in the internal controls and information on any fraud that involves employees who are involved with internal control activities; (2) any significant changes in internal controls or related factors that could have a negative impact on the internal controls. Management not only provide an assessment of internal controls, but also auditors provide an opinion on management's assessment.

Most of the internal control weakness disclosures are related to financial systems and procedures. This group typically involves financial closing processes, account reconciliation, or inventory processes. For example, one company disclosed problems with ''the design and effectiveness of internal controls relating to receivables from suppliers''. Personnel issues rank as the second largest category of weakness disclosures. This category is related to the poor segregation of duties, inadequate staffing, or other related training or supervision problems. For example, other company cited a ''lack of sufficient personnel with appropriate qualifications and training in certain key accounting roles.'' Other common types of weaknesses include revenue recognition, documentation, and IT system and controls (e.g., security and access controls, backup and recovery issues). In addition, issues related to international operations and mergers and acquisitions are sources of weakness disclosure, although they represent a relatively small percentage of all disclosures.

Based on their severity, these internal control problems are classified into three types: material weakness, significant deficiency, and control deficiency. Auditing Standards defines a material weakness as ''a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual financial statements will not be prevented or detected.'' Under Auditing Standards, a significant deficiency is ''a control deficiency, or a combination of control deficiencies, that adversely affects the company's ability to initiate, authorize, record, process, or report external financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the company's annual financial statements that is more than inconsequential will not be prevented or detected.'' A control deficiency occurs ''when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatement on a timely basis.'' For the sake of brevity, we will refer to material internal control weaknesses as internal control weaknesses hereafter.

[1] COSO stands for the Committee of Sponsoring Organizations of the Treadway Commission

2.2. Audit committee quality and internal control

Since an entity's internal control is under the purview of its audit committee, we investigate the relation between audit committee quality and internal control weaknesses. The audit committee not only plays an important monitoring role to assure the quality of financial reporting and corporate accountability, but also serves as an important governance mechanism, because the potential litigation risk and reputation impairment faced by audit committee members ensure that these audit committee members discharge their responsibilities effectively. We thus expect that firms with high-quality audit committees are less likely to have internal control weaknesses than firms with low-quality audit committees.

On measuring audit committee quality, we focus on the financial expertise in these committees. It is recommended that each audit committee have at least one financial expert highlights the importance of the financial literacy and expertise of audit committee members. Such financial expertise of audit committee members has been shown to be important for dealing with the complexities of financial reporting and for reducing the occurrence of financial restatements. In addition, audit committee members with financial reporting and auditing knowledge are more likely to understand auditor judgments and support the auditor in auditor-management disputes than members without such knowledge. Moreover, financially knowledgeable members are more likely to address and detect material misstatements. Audit committee members with financial expertise can also perform their oversight roles in the financial reporting process more effectively, such as detecting material misstatements. Indeed, there is a significantly negative association between an audit committee having at least one member with financial expertise and the incidence of financial restatement. Audit committees with financial expertise are less likely to be associated with the incidence of internal control problems.

Hypothesis 1. Firms with greater audit committee financial expertise are less likely to have internal control weaknesses.

Audit committees with accounting financial expertise improve corporate governance. Therefore, we further separate audit committee financial expertise into accounting financial expertise and nonaccounting financial expertise and test the relation between these two variables and internal control weaknesses.

An audit committee member is a financial expert if he or she can be classified into the following two categories:

(a) an accounting financial expert who has experience as a public accountant, auditor, principal or chief financial officer, controller, or principal or chief accounting officer;

or

(b) a non-accounting financial expert who has experience as the chief executive officer, president, or chairman of the board in a for-profit corporation, or who has experience as the managing director, partner or principal in venture financing, investment banking, or money management. With this definition, we measure audit committee financial expertise as the percentage of audit committee members who are financial experts. We further separate audit committee financial expertise into accounting financial expertise, measured as the percentage of audit committee members who are accounting financial experts, and non-accounting financial expertise, the percentage of audit committee members who are non-accounting financial experts.

2.3. Auditor independence and internal control

Auditor independence can be related to the disclosure of a firm's internal control problems. When there is a strong economic bond between an auditor and a client firm, the auditor has an incentive to ignore potential problems and issue a clean opinion on the client firm's internal controls. While some studies find no relation between non-audit fees and auditor independence and argue that an auditor's concern with maintaining its reputation for providing high-quality audits could restrain it from undertaking activities that jeopardize independence, since the revenue from each client will be a small percentage of the auditor's total revenue, other studies suggest that the provision of non-audit services compromises auditor independence. Non-audit services are associated with increased discretionary accruals and the achievement of certain earnings benchmarks. For example, the abnormal returns for Andersen's clients around Andersen's indictment are significantly more negative, when the market perceived the auditor's independence to be compromised. Given these mixed empirical findings, we measure auditor independence as the ratio of the audit fee to the total fee, and propose the non-directional null hypothesis, as follows.

Hypothesis 2. Auditor independence is not associated with the disclosure of internal control weaknesses.

2.4. Control variables

2.4.1. Audit committee

In addition to audit committee financial expertise, other attributes of an audit committee have been found to be important factors in effective monitoring. Specifically, we control for audit committee independence, there is a positive relation between audit committee independence and the quality of internal control. An audit committee member is independent, if he or she is not affiliated with the firm and does not accept any consulting fees.

We next control for the natural logarithm of audit committee size, measured as the number of audit committee members, because research suggests that a large audit committee tends to enhance the audit committee's status and power within an organization. We thus expect that a large audit committee is more likely than a small one to improve the quality of internal controls, because increased resources and enhanced status will make the audit committee more effective in fulfilling its monitoring role.

We also control for the natural logarithm of audit committee meetings, measured as the number of audit committee meetings held each year, because research shows that effective audit committees meet regularly. However, it is also possible that an audit committee meets more frequently to discuss internal control issues, when there are significant problems associated with a firm's internal controls. Therefore, we make no prediction on the relation between the number of audit committee meetings and the quality of internal controls.

2.4.2. Board of directors

The quality of an entity's internal controls is a function of the quality of its control environment that includes the board of directors and the audit committee. First, we focus on board independence, measured as the percentage of outside directors on the board[2], because research suggests that board independence is negatively related to the likelihood of financial fraud. We also control for the natural logarithm of board size, measured as the number of directors on the board. While some researchers find that a large board has more expertise than a small one, that it tends to be more effective in monitoring accruals, others suggest that a small board is more effective in mitigating the agency costs associated with a large board. Given the mixed empirical evidence on board size, we expect that the relation between board size and the likelihood of internal control weaknesses is indeterminate. Finally, we control for the natural logarithm of board meetings, as measured by the number of board meetings held each year. While board meeting frequency is important to improve board effectiveness, it is inversely related to firm value, because of the increased board activities following share price declines. Since board independence, size, and meeting frequency all influence a board's effectiveness, they, in turn, are related to the quality of internal controls.

2.4.3. Auditor types

We use a dummy variable (BIG4) to measure auditor type, because a firm's decision to hire a Big 4 auditor is likely to be associated with internal controls for several reasons. Smaller and less profitable firms are more likely to have internal control problems than larger or more profitable ones. On the one hand, such firms with internal control problems are less likely to hire a Big 4 auditor, because they are constrained by financial resources and cannot afford it. On the other hand, they might also be avoided by the Big 4 auditors, because they are perceived as being risky and may expose the Big 4 to potential litigation. Given that a firm shunned by a Big 4 auditor may signal that it has potential internal control problems, we introduce the dummy variable BIG4 to control for auditor quality.

2.4.4. Auditor changes

Firms with recent auditor changes are likely to have internal control problems. On the one hand, auditors may drop risky clients as part of their risk management strategies, since firms with material internal control weaknesses may represent high audit failure risk. On the other hand, firms may dismiss auditors for lack of performance, when the firms discover material internal control weaknesses.

2.4.5. Other variables

We also control for firm characteristics that may be associated with internal control problems. Small and high growth firms are likely to have internal control weaknesses, we control for size, measured as the natural logarithm of total assets (TA), and growth, measured as industry-median-adjusted sales growth. It may take some time for a firm that recently engaged in mergers and acquisition to integrate different internal control systems; consequently, such a firm is more likely to have internal control problems. A firm experiencing restructuring is also likely to have internal control

[2] Outside directors are those who are not affiliated with the firm, other than serving on its board.

problems, because of the loss of experienced and valuable employees and because of the dramatic changes associated with such an event Also, firms with greater complexity and scope of operations are more likely to have internal control problems than those without.

3. Conclusion

In this paper, we examine the relation between audit committee quality, auditor independence, and the disclosure of internal control weakness.

The results from our conditional logit analyses suggest that a relation exists between audit committee quality, auditor independence, and internal control weaknesses. Firms are more likely to be identified with an internal control weakness, if their audit committees have less financial expertise or, more specifically, have less accounting financial expertise and non-accounting financial expertise. They are also more likely to be identified with an internal control weakness, if their auditors are more independent. In addition, firms with recent auditor changes are more likely to have internal control weaknesses.

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