Financial Reporting and External Audit

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Financial Reporting

• Accurate financial reporting is critical for the efficiency of capital markets and the proper valuation of securities.

• It allows the board and investors to make an informed evaluation of strategy, business model, and risk.

• It also allows the board to structure compensation packages appropriately and award performance-based compensation knowing that predetermined targets were met.

• It is the role of the audit committee to help to ensure the accuracy of reports:
  1. Sets parameters for quality, transparency, and controls.
  2. Hires external auditor to test for misstatement.
The Audit Committee

- The audit committee has a broad range of responsibilities:
  - Oversee financial reporting and disclosure
  - Monitor choice of accounting principles
  - Hire and monitor the external auditor
  - Oversee internal audit function
  - Oversee regulatory compliance
  - Monitor risk

- To ensure that its work is free from management influence:
  - All committee members must be independent
  - All member must be “financially literate”
  - One member must be a “financial expert”

- The Sarbanes Oxley Act of 2002 mandates these requirements.
Accounting Quality

• The audit committee establishes guidelines that dictate the quality of accounting used in the firm:

• **Quality**: the degree to which accounting figures precisely reflect changes in financial position, earnings, and cash flow.

• **Transparency**: the degree to which the company provides details that supplement and explain accounts reported in statements and filings.

• **Internal controls**: the processes and procedures that ensure transactions are accurately recorded, financial statements reliably produced, and company assets protected from theft.

90% of audit committee members believe they are effective or very effective in overseeing management’s use of accounting

KPMG (2009)
Accounting Quality: Evidence

• Despite the confidence among committee members, some evidence suggests companies are not as effective as they believe in preventing abuse by management.

• Companies are much less likely to report a small decrease in earnings than a small increase.

• Managers make small manipulations in accounts so that net income figures are rounded up rather than down.

• Companies that beat earnings with “low-quality” earnings have better short-term but worse long-term performance.

Burgstahler and Dichev (1997); Carslaw (1988); Grundfest and Malenko (2009); Bhojraj, Hribar, Picconi, and McInnis (2009)
Financial Restatements

A restatement occurs when a material error is found in the company’s previously published financials. 200 to 500 U.S. public companies restate each year.


- Expense Recognition, 22%
- Misclassification, 18%
- Comprehensive Income, 8%
- Equity, 6%
- Inventory, 3%
- Acquisition / Investments, 6%
- Capital Assets, 6%
- Tax Accounting, 11%
- Revenue Recognition, 10%
- Expense Recognition, 11%
- Other, 3%
- Reserves, 3%
- Revenue Recognition, 10%
- Liabilities, 3%
- Other, 3%

Glass Lewis (2009)
Reasons for Restatements

- A restatement can occur because of human error, aggressive accounting, or fraud.
- The reasons for restatement have implications on the quality of controls in the company and the steps needed to remedy.

- Some evidence that financial fraud is correlated with weak governance, including:
  - Few outside directors
  - Low director stock ownership
  - Busy boards
  - Fewer accounting meetings
  - Fewer financial experts on audit committee

- However, evidence is not conclusive. Others have found no relation to size, composition, and experience of board or to frequency of meetings.
- Companies exhibit 5% median stock price decline following announcement of restatement; decline is 20% if due to fraud.

Beasley (1996); Farber (2005); COSO (2010); Palmrose, Richardson, and Scholz (2005)
Models to Detect Manipulation

- Researchers have put tremendous effort into developing models to detect fraud— with limited success.

- One set of models measures accounting quality in terms of “abnormal accruals” (the degree of divergence between reported net income and actual cash flows).

- Another set of models analyzes both accounting and governance data. This improves success rate slightly.

- Recently, researchers have explored linguistic analysis of CEO and CFO speech. This also improves success rate.

Still, precision in these models is low (less than 10 percent).

Beneish (1999); Audit Integrity (2010); Larcker and Zakolyukina (2010)
External Audit

- The external audit assesses the validity and reliability of publicly reported financial information.

- Because management is responsible for preparing financial reports, shareholders expect an objective third party to provide assurance that the information is accurate.

- Despite public expectations, it is not the explicit objective of the audit to identify fraud.

- Instead, the objective is to express an opinion on whether statements comply with accounting standards. Auditors express an “unqualified opinion” if it finds no reason for concern.
External Audit Process

1. Audit preparation: Determine scope of audit. Identify areas requiring special attention.


4. Assess internal controls: Examine design. Identify weaknesses. Focus on key accounts and unusual transactions.

5. Conclude: Review findings with audit committee. Express an opinion to accompany the financial statements.
Audit Quality

- Given the importance of the audit, much attention has been paid to factors that might impact audit quality.

- Potential issues include:
  1. Industry consolidation
  2. Conflict when auditor provides non-audit services
  3. Conflict when former auditor is hired as CFO
  4. Auditor rotation

- What impact, if any, do each of these have on the likelihood of future restatement or fraud?
1. Industry Consolidation

In the late 1980s, there were eight major accounting firms. Currently there are four (the “Big Four”)

- (+) Scale of audit firms matches the scale of companies
- (+) Expertise by industry and region
- (+) Expertise by function (tax, audit, systems, etc.)
- (-) Inadequate number of firms to choose among
- (-) Decreased competition might lead to increased fees

- 60% of large companies believe there is an inadequate number of audit firms. Fewer than 25% of small companies believe this.
- Audit fees have risen, but this is likely due to greater cost of compliance with SOX, greater scope, more expensive personnel.
- Splitting up Big Four would reduce expertise and decrease quality.

GAO (2008)
2. Non-Audit Services

Sarbanes Oxley prohibits auditors from performing certain non-audit services.

- (+) Reduces potential conflict of interest
- (+) Might improve auditor independence
- (+) Company cannot “retaliate” if it disagrees with auditor
- (-) Auditor has expertise in company procedures
- (-) Might be cheaper for company

- No evidence that this practice hurts audit quality (measured by abnormal accruals, earnings conservatism, failure to issue qualified opinion, or future restatement).
- Congress did not take into account this disconfirming evidence, even though it was widely understood at the time.

Romano (2005)
3. Former Auditor as CFO

A company might decide to offer a job in finance, treasury, or internal audit to a member of the external auditing team.

- (+) Auditor is familiar with company and its procedures
- (+) Company is familiar with auditor working style
- (+) Reduces both hiring costs and risk of failure
- (-) Auditor might have allegiance to former employer
- (-) Auditor knows internal controls, might facilitate fraud

- Mixed evidence.
- Some studies find decrease in earnings quality when company hires former auditor as CFO.
- Others find no relation between source of hire and earnings quality.

Dowdell and Krishnan (2004); Geiger, North, and O'Connell (2005)
4. Auditor Rotation

Auditor rotation is the practice of periodically changing external audit firms.

- (+) New auditor might be more independent
- (+) New auditor has fresh perspective
- (-) Costly to change audit firms or audit teams
- (-) New auditor has a steep learning curve

- Very little evidence that auditor rotation is cost-effective or that it improves audit quality.
- However, auditor resignation (auditor quits because of disagreement with management) might be a warning sign of fraud.

Cameran, Merlotti, and Di Vincenzo (2005); Whisenant, Sankaraguruswamy, and Raghunandan (2003)
Conclusions

• The audit committee plays an important role in ensuring the integrity of financial reporting by working with management to determine standards for quality, transparency, and controls.

• The audit committee also hires and oversees the work of the external auditor.

• Still, there are few reliable models that the board can use to detect accounting manipulation.

• Audit committee effectiveness likely depends not only on qualification but engagement.

• Superficial constraints on auditors (such as rotation, cooling off periods, and prohibition of non-audit services) are not likely to improve earnings quality.


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Bibliography


