Auditing Companies with Poor Internal Control:

Examining Audit Fees, Material Weaknesses, and Accounting Firms

A. Background and Significance

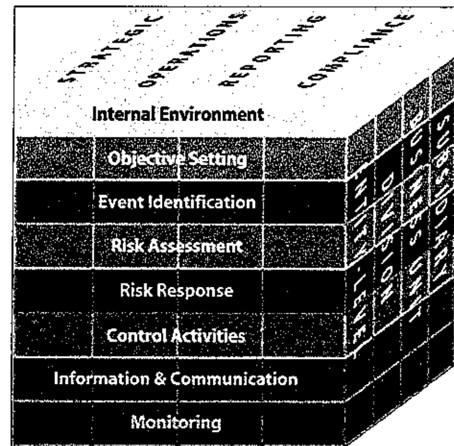
Accounting information, free from misstatement, is critical to the decision making of firms and investors. Virtually every company establishes a system of internal controls to prevent or detect errors that would materially affect key financial information. The AICPA defines internal control as, "a process effected by management . . . to provide reasonable assurance regarding the achievement of objectives and the reliability of financial reporting," (AICPA 2007). When internal controls work properly, they support efficient operation, maintain reliable accounting information, and promote adherence to regulation standards. They can also help facilitate company audits; where an auditor is satisfied by a firm's internal controls, she can use a reliance approach and forgo certain substantive testing.

In response to the far-reaching accounting scandals at the turn of the 21st century (i.e. Enron, WorldCom, and Tyco), Congress enacted the Sarbanes-Oxley Act to impose more strict regulation on the way publicly traded companies manage financial information. SOX 302 places ultimate responsibility on management to establish and maintain internal controls over financial reporting. For each fiscal year, management must conduct an evaluation of the company's internal controls and report on their effectiveness. SOX 404 subsequently requires that, as a part of each audit report, public accounting firms provide an opinion with regards to the internal control evaluation made by management; adverse opinions are issued whenever material weaknesses are identified (SEC, 2002).

A material weakness is defined as, "a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected," (PCAOB 2004). These serious control deficiencies can be derived from many sources, including the following:

- An insufficient number of accounting personnel with GAAP expertise
- Poor segregation of duties of employees (access controls, etc.)
- The ineffective implementation of a new information system
- Incorrect treatment of complicated accounts (deferred taxes, derivatives, etc.)
- Failure to perform basic risk assessment/monitoring procedures

These are but a sample of the control deficiencies that can conceivably lead to material misstatements in the financial reporting process. Because many companies perform their annual evaluation using the COSO *Internal Control – Integrated Framework*, the quantity of potential material weakness



ITEM 9A. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Our senior management is responsible for establishing and maintaining a system of disclosure controls and procedures (as defined in Rule 13a-15e and 1934 (the "Exchange Act")) designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is re within the time periods specified in the Securities and Exchange Commission's rules and forms. Disclosure controls and procedures include, without limitation, information required to be disclosed by an issuer in the reports that it files or submits under the Exchange Act is accumulated and communicated to the issuer's officer or officers and principal financial officer or officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required

Management, including our Chief Executive Officer and Chief Financial Officer, performed an evaluation of our disclosure controls and procedures as defined Based on this evaluation and the identification of material weaknesses in our internal control over financial reporting as described below, our Chief Executive O concluded that our disclosure controls and procedures were not effective as of December 31, 2009.

Management's Report on Internal Control Over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting, as defined in Exchange Act Rule 13a-15 process designed by, or under the supervision of, our Chief Executive Officer and Chief Financial Officer, to provide reasonable assurance regarding the reliabi financial statements for external purposes in accordance with GAAP and includes those policies and procedures that:

i. Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of assets of the com

ii. Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAA company are being made only in accordance with authorizations of management and directors of the Company; and

B. Statement of Intent

The data used in this examination is composed of a sample of several hundred publicly traded companies that reported one or more material weaknesses during the years 2004-2013. Some of these corporations are well known giants (e.g., Freddie-Mac, General Motors, and Merrill Lynch) whereas others are much smaller companies. Information supplied for each company includes the accounting firm that performed the audit, the total audit and non-audit fees billed to the company, gross revenues for the period, net income, and total assets. I was given this data file by my thesis advisor, Dr. Bill Heninger, who had obtained it through Audit Analytics.

There are three main research topics that I would like to examine in this thesis:

1. *Material Weaknesses and Audit Fees*

   An attempt to empirically determine a cause of material weaknesses would be meaningless; they are "caused" by structuring/running a company in such a way that breaks accepted standards regarding financial information management. What I would like to observe is the characteristics of corporations that have such deficiencies in internal control. Does the size of the company impact the number of material weaknesses identified? Are more weaknesses identified if the audit was performed by a Big 4 firm? I would also like to examine how material weaknesses impact the amount of audit fees the accounting firms charge their clients.

2. *Indicators of a Big 4 audit*

   It is cited by some that the Big 4 accounting firms (PricewaterhouseCoopers, Ernst & Young, Deloitte & Touche, and KPMG) audit more than 80% of all U.S. publicly traded companies (Big 4, 2015). In my sample, the Big 4 performed the audits of approximately

60% of these companies with poor internal control. This led me to wonder if there are subtle ways to identify whether or not a company was audited by a Big 4 firm. If they audit a smaller portion of those companies with control deficiencies, could the number of identified material weaknesses indicate whether or not it was a Big 4 audit? I would imagine that the biggest companies in the U.S. prefer the reputation of a Big 4 firm's stamp of approval on their financial statements. Is this assumption consistent with the data?

3. *Differences between Big 4 Firms*

I also want to determine if there are any significant differences between the Big 4 firms. Ernst and Young had audited considerably fewer of these companies than the other Big 4 firms. Also, companies audited by PwC identified at least one more weakness on average than any other firm. A comparison of the Big 4 firms' audits of material weakness companies is provided:

# of audits performed, (% of total)	
PwC – 110, (30.2%)	Ernst and Young was engaged in less than half as many audits of material weakness companies as the next lowest Big 4 firm, KPMG.
EY – 47, (12.8%)	
Deloitte – 114, (31.1%)	
KPMG – 95, (25.9%)	

Average # of MWs identified	
PwC – 5.3	On average, companies audited by PricewaterhouseCoopers identify one more weakness than the next highest Big 4 firm, Deloitte.
EY – 3.7	
Deloitte – 4.3	
KPMG – 4.1	

Is EY issuing fewer adverse opinions on internal control due to chance? Do they have stricter standards in client acceptance, or are they experiencing an issue with due

diligence? Does PwC go the extra mile when evaluating the controls of its clients? Do their clients strive for more transparency than other material weakness companies?

These research questions are relevant to accounting professionals, those who manage large corporations, and investors/creditors who provide capital to such firms. This analysis should prove insightful as to the characteristics of companies that have material weaknesses, as well as those accounting firms that audit them.

C. Methodology/Procedures

As aforementioned, I will use a data file of several hundred companies that reported ineffective internal control over financial reporting to examine the research topics listed in the previous section. A considerable part of the file requires validation/completion; examining each company's 10-K filing using EDGAR, I will confirm the count and nature of the material weaknesses for each company and I will fill in the financial information (audit fees, total assets, etc.) where gaps exist.

I will use the statistical software, STATA 14, to conduct this empirical examination. I will run basic regressions on several variables (e.g. material weakness count, audit fees, etc.) and test for statistically significant relationships. This econometric analysis should prove sufficiently robust to draw conclusions regarding the research topics at hand.

D. Human and Animal Subjects Approval

No human or animal subjects will be required for this research.

J. Expenses/Budget

I will not require outside funding for this project.

K. Other and Closure

No further comment.

L. References

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