Management's Materiality Criteria of Internal Control Weaknesses and Corporate Fraud: Evidence from China

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ABSTRACT

This paper investigates the determinants and consequence of Chinese listed companies' first-time decisions on materiality criteria for internal control weaknesses, which have been observable beginning from the 2011 annual report. Although pretax income is most commonly used as the benchmark for materiality, revenue is also used as a popular alternative. Revenue is more susceptible to manipulation, as it has a much larger financial amount than pretax income. We argue that unethical managers prefer not to disclose material weaknesses by manipulating the materiality criteria to justify non-disclosure of a potentially material weakness. Consistent with this opportunistic incentive, we find that when companies committed fraud in the previous year that remains undetected, their management is more likely to use revenue (rather than pretax income) as the first-time benchmark and to set a higher revenue-based materiality threshold as well. Moreover, once the materiality metrics are set, the first-time revenue-based materiality threshold is significantly and positively associated with subsequent incidence of corporate fraud, which suggests that setting deviant and loose materiality metrics leaves room for the management to engage in future misconduct.

1. Introduction

This study examines the determinants and consequence of management's first-time decisions on materiality criteria for internal control (IC) weaknesses in China. In 2010, Chinese regulators required that Chinese listed companies self-assess the effectiveness of IC and establish their own criteria to differentiate among a material weakness, a significant deficiency, and a control deficiency. Since no materiality criteria had been established before the regulation, the Chinese setting provides an opportunity to examine the factors that likely affect management's first-time decisions on IC materiality. Among others, we are particularly interested in testing whether the disclosed materiality criteria reflect management attitude toward existing corporate fraud. This is because management attitude toward fraud is usually difficult to observe, and the attitude element of the fraud triangle remains an under-researched area (Hogan, Rezaee, Riley, and Velury, 2008; Murphy and Dacin, 2011; Trompeter, Carpenter, Desai, Jones, and Riley, 2013). First-time disclosures of IC materiality criteria in China likely reveal management attitude toward existing fraud through the management's choices of materiality metrics.

Prior studies find that opportunistic managers tend to mislead themselves and not to disclose IC material weaknesses (Bedard and Graham, 2011; Files, Swanson, and Tse, 2009; Rice and Weber, 2012). Professional literature also refers to
management’s manipulation of IC weaknesses or accounting materiality as red flags of fraud (American Institute of Certified Public Accountants [AICPA], 2002, Sec.316.85). We argue that when given the opportunity to set IC materiality criteria, managers who are aware of existing but undetected fraud are incentivized to manipulate materiality criteria in the first place to justify non-disclosure of IC material weaknesses.

Chinese listed companies were given such an opportunity to establish their initial criteria of IC materiality beginning from the 2011 annual report. By the 2014 annual report, about 82% of Chinese listed companies have established IC materiality criteria. We test whether opportunistic managers manipulate materiality criteria by hand-collecting and analyzing companies’ first-time disclosure of IC materiality.

There are two major elements inherent in materiality criteria: 1) the base for calculating materiality, and 2) the percentage rate to multiply by that base (Steinbart, 1987). Among Chinese listed companies, the most commonly used base is pretax income, while a less common one is revenue. We argue that the revenue benchmark is more susceptible to manipulation than the pretax income base because revenue has a much larger financial amount than the pretax income, while still being related to the income statement.

We find that when companies committed fraud in the prior year that remains undetected, the management is more likely to choose revenue rather than pretax income as the first-time benchmark. In contrast, there is no significant association between an existing and detected fraud and the selection of revenue as the benchmark. Moreover, companies using revenue as the base are more likely to select a higher percentage rate if they committed fraud in the prior year that remains undetected. For companies using the most common base (i.e., pretax income), we do not find a similar pattern. Collectively, these findings support our hypothesis that managers with existing but undetected misconduct allow room for themselves by manipulating IC-related materiality metrics, once given the opportunity to do so.

What is the consequence of manipulating the materiality criteria in the first place? We argue that if opportunistic managers manipulated the materiality criteria, they expect to be less constrained by ICs, thus having more freedom to engage in future fraud. In other words, we expect to find that companies with a higher level of first-time materiality threshold are more likely to mislead themselves, once the materiality criteria are established. To test this, we regress the likelihood of corporate fraud in any years since the establishment of IC-related materiality criteria on the initial IC materiality threshold, while controlling for the potential selection bias in management’s use of a particular financial benchmark (i.e., revenue versus pretax income) as well as other factors that likely affect the incidence of fraud. We find a significant and positive association between the first-time revenue-based materiality threshold and subsequent incidence of corporate fraud. In contrast, we do not find a significant association between the first-time pretax income-based materiality and subsequent fraud incidence. These findings are consistent with the notion that deviant and loose IC materiality metrics leave room for the management to engage in misconduct.

Our study contributes to the literature in several ways. First, as the attitude element of the fraud triangle has received the least amount of attention in the accounting literature (Hogan et al., 2008; Trompeter et al., 2013), our study adds to the very few studies along this line (e.g., Cohen, Ding, Lesage, and Stolowy, 2011; Murphy, 2012). Specifically, we show that when managers are aware of existing but undetected fraud, they tend to set a deviant and loose IC policy (through materiality metrics) when given the opportunity to do so. In contrast, there is no significant association between existing and detected fraud and the setting of a deviant and loose IC policy. These findings provide evidence on management tolerance and opportunism for corporate fraud (in an emerging market).

Second, we contribute to prior research on materiality. Most studies in this line of literature focus on materiality judgment from the auditor’s perspective. Our study is among the few that focus on materiality from the management’s perspective (e.g., Acito, Burks, and Johnson, 2009; Liu and Mittelstaedt, 2002). Moreover, among the prior few studies on management’s materiality decisions, surrogates for the preparer’s materiality decision are most likely implied (Holstrum and Messier, 1982; Messier et al., 2005). To our knowledge, this study is among the first to examine the determinants and consequence of management’s explicit and first-time materiality metrics.

Third, our study adds to the literature on IC weaknesses. Prior studies find that management often underestimates the severity of IC deficiencies (Bedard and Graham, 2011) and has incentives to not even report existing material weaknesses (Rice and Weber, 2012). Our study offers evidence on another form of management opportunism, i.e., through manipulating the very definition of materiality of IC weaknesses.

We proceed as follows. Section 2 introduces the institutional background and develops research hypotheses. Section 3 describes materiality metrics in China and the sample selection. Section 4 examines the determinants of management’s first-time materiality metrics and tests our first set of hypotheses. Section 5 tests our second set of hypotheses by examining the association between management’s first-time materiality metrics and subsequent incidence of corporate fraud. Section 6 concludes the paper.

2. Institutional background and development of research hypotheses

2.1. Materiality metrics and management discretion

The concept of materiality pervades the financial accounting and reporting process, influencing decisions regarding the collection,
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