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Organized labor, audit quality, and internal control☆

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ABSTRACT

This study investigates whether labor union strength is associated with the quality of audits and internal control. Labor unions have reason to demand high quality audits and strong systems of internal control because they rely on financial information in collective bargaining negotiations. However, organized labor creates incentives for managers to procure lower quality audits and provide weaker internal control in order to hold greater influence over the content of the financial information that unions receive. I provide evidence that union strength is associated with higher audit quality and better internal control. Specifically, I find that union strength is associated with higher audit fees, fewer audit failures, and fewer material weaknesses.

1. Introduction

This study examines whether labor union strength is associated with the quality of audits and internal control. Labor unions have reason to demand high quality audits and strong internal control because they rely on financial information in collective bargaining negotiations. However, managers of unionized firms have incentives to procure lower quality audits and provide weaker internal control in order to hold greater influence over the content of the financial information that unions receive. Given these opposing incentives, whether union strength is associated with higher or lower quality audits and internal control is an empirical question.

During collective bargaining negotiations, compensation arguments often focus on the financial condition of the firm, and financial information frequently has an important role in shaping the course of the negotiations (Brown, 2000). However, managers are generally not required to provide unions with financial information,[1] so unions often have to rely on published financial reports (Brown, 2000; Cheng, 2011; Mautz & Richardson, 1992). As a result, labor unions are at a substantial informational disadvantage relative to management. Prior research argues that decreasing information asymmetry is beneficial to unions because it allows them to negotiate more proficiently (e.g., Cheng, 2011; Hilary, 2006; Kleiner & Bouillon, 1988).

Since financial information is important in the negotiations, and being more informed allows unions to negotiate more proficiently, unions have reason to prefer high quality financial information because it is more reliable and more informative. However, since reduced information asymmetry allows unions to obtain a better bargaining position, managers have incentives to maintain an informational advantage over unions. Managers can accomplish this by withholding financial information from unions or by lowering its quality through manipulation or obfuscation. This study investigates how the opposing incentives of unions and managers affect two factors that significantly influence the quality of financial information: auditing and internal control.

The first question I examine is whether union strength is associated with audit quality. DeFond and Zhang (2014) define higher audit quality

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[1] An exception occurs when management argues that the firm is unable to afford a union demand or argues that the demand will affect the firm's ability to remain competitive (Carrell & Heavrin, 2009; Efrain Rivera-Vego et al. v. Conagra, Inc. 1995; NLRB v. Truitt Manufacturing Co.). When this happens, management must provide financial information that is "relevant and necessary" to substantiate the claim of inability to pay (Carrell & Heavrin, 2009; Holley et al., 2008; NLRB 1997; NLRB v. Truitt Manufacturing Co.). However, even when the obligation to provide financial information is present, managers are not required to completely "open the books" to unions because management has the right to protect business or trade secrets (Hilary, 2006). Thus, management still retains "wide discretion over the form and content of the reports provided" to union negotiators (Brown, 2000).

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as "greater assurance that the financial statements faithfully reflect the firm's underlying economics, conditioned on its financial reporting system and innate characteristics."[2] The achieved level of audit quality depends on both the firm's demand for audit quality and the auditor's ability and incentives to supply audit quality (DeFond & Zhang, 2014). Unions are likely to prefer high quality auditing because it encourages the production and distribution of reliable information. In contrast, managers of unionized firms may prefer lower audit quality because it provides them with greater control over the content of the financial information available to unions.

I also examine whether labor union strength is associated with the quality of internal control. Unions have reason to demand strong internal control because it produces higher quality financial information. For example, prior research finds that material weaknesses in internal control over financial reporting (henceforth "material weaknesses") are associated with lower earnings quality (e.g., Ashbaugh-Skaife, Collins, Kinney, & LaFond, 2008; Bedard, Hoitash, Hoitash, & Westermann, 2012; Chan, Farrell, & Lee, 2008; Doyle, Ge, & McVay, 2007b) and greater uncertainty in earnings (Clinton, Pinello, & Skaife, 2014; Xu & Tang, 2012). In addition, because strong internal control increases the quality of pre-audit financial information, unions benefit from strong internal control if management provides them with current-year financial information that has not yet been audited. In contrast, managers of unionized firms may prefer weaker internal control because it facilitates managerial manipulation (Chan et al., 2008; Donelson, Ege, & McInnis, 2014) and promotes information asymmetry (Skaife, Veenman, & Wangerin, 2013), which can help managers maintain an informational advantage over organized labor.

To test my hypotheses, I use three measures of union strength, including two that were generated from data I obtained by filing a Freedom of Information Act request with the Federal Mediation and Conciliation Service. My results provide evidence that union strength is associated with higher audit quality and better internal control. Specifically, I find that union strength is associated with higher audit fees, fewer audit failures, and fewer material weaknesses. In each case, the associations are economically significant. In addition, my results are also robust to utilizing a propensity score matching approach.

This study provides three primary contributions to the literature. First, I identify union strength as a factor that affects the demand for audit quality. Prior research generally assumes that the demand for audit quality arises from shareholders, creditors, and regulators. I contribute to the audit quality literature by identifying organized labor as an additional stakeholder that drives the demand for audit quality. Second, in finding that union strength is associated with fewer material weaknesses, I contribute to the literature that explores the determinants of the quality of internal control. Prior research identifies a variety of factors that influence the quality of internal control, but it does not consider organized labor. In light of the first two contributions of this study, future researchers may want to consider controlling for labor union strength when investigating research questions concerning audit quality and internal control. Third, I also contribute to the labor relations literature that examines the impact of organized labor on the firm. By showing that union strength improves the quality of audits and internal control, I build upon the research that demonstrates the power of unions to influence firm policies.

The remainder of this paper proceeds as follows. Section 2 provides a review of the relevant literature, Section 3 develops the hypotheses, Section 4 discusses the methodology, Section 5 presents the results, and Section 6 concludes.

[2] Another commonly cited definition of audit quality comes from DeAngelo (1981); she defines audit quality as "the market-assessed joint probability that a given auditor will both (a) discover a breach in the client's accounting system, and (b) report the breach."

2. Prior literature

Prior research has investigated the relation between labor unions and earnings quality. These studies have yielded very mixed results. For example, Liberty and Zimmerman (1986) fail to find evidence that managers bias earnings downward during collective bargaining negotiations. In contrast, DeAngelo and DeAngelo (1991) investigate a small sample of firms in the steel manufacturing industry and provide evidence of lower earnings during union contract negotiations. More recently, Leung, Li, and Rui (2009) find that union strength is associated with greater conservatism, but Farber, Hsieh, Jung, and Yi (2012) find the opposite. Existing research also suggests that union strength is associated with earnings smoothing (Hamm, Jung, & Lee, 2013) and a greater propensity to fail to meet analysts' earnings forecasts (Bova, 2013).

Extant research also examines the impact of organized labor on the information environment. For example, Hilary (2006) finds that union strength is associated with greater information asymmetry, where bid-ask spreads, the probability of informed trading (PIN), trading volume, and analyst coverage are used as measures of information asymmetry.[3] Also, Cheng (2011) argues that managers of unionized firms are likely to prefer private debt financing because they can convey financial information to lenders confidentially, thereby avoiding public disclosure of additional financial information and preventing it from being accessed by unions. He finds evidence consistent with this conjecture. Finally, Scott (1994) investigates a sample of firms in Canada and finds that when union strikes are more likely, managers make less voluntary disclosures about pension plans, which is important information in union negotiations.

3. Development of the hypotheses

3.1. Labor union demand for high quality financial information

Financial information often has an important role in collective bargaining negotiations.[4] For example, when a firm is experiencing high profitability, unions frequently argue that the firm can afford compensation increases (Carrell & Heavrin, 2009; Holley, Jennings, & Wolters, 2008).[5] Or, when management argues that the firm is unable to afford a union's demands, financial information is used to assess the veracity of that claim. Accounting information is also routinely referenced by union representatives to justify accepting or rejecting a proposal (Oakes, 1992). However, even when the firm's ability to pay for a union's demands is not explicitly a bargaining issue, the firm's financial condition often shapes the course of the negotiations (Brown, 2000). For example, Brown (2000) notes:

> Even when the focus of negotiations is on factors other than profitability, ability to pay may be significant as a background psychological factor (Schein, 1988). It may help to determine bargaining limits. Unions may, for example, fail to push a claim for fear that financial pressures will lead to layoffs (Brown, 2000).

[3] The quality of a firm's entire information environment is a broader construct than the quality of its financial information. For example, the measures of information asymmetry used by Hilary (2006) are affected by all sources through which information about a firm is disseminated, such as voluntary disclosures and news stories, which can contain information that is not available in accounting reports. If unions tend to fixate on accounting figures, then managers may acquiesce to a union's demand for high quality financial information, while lowering the quality of the overall information environment in other ways, such as by making fewer voluntary disclosures.

[4] Most collective bargaining contracts are for three year terms (Holley et al., 2008).

[5] As one example, during a labor union strike at Caterpillar in 2012, *The New York Times* reported that Timothy O'Brien, a labor union representative, said "A company that earned a record $4.9 billion in 2011 and $1.586 billion in the first quarter of this year should be willing to help the workers who made those profits for them" (Greenhouse, 2012).