

Accruals Quality and Internal Control over Financial Reporting

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We examine the relation between accruals quality and internal controls using 705 firms that disclosed at least one material weakness from August 2002 to November 2005 and find that weaknesses are generally associated with poorly estimated accruals that are not realized as cash flows. Further, we find that this relation between weak internal controls and lower accruals quality is driven by weakness disclosures that relate to overall company-level controls, which may be more difficult to “audit around.” We find no such relation for more auditable, account-specific weaknesses. We find similar results using four additional measures of accruals quality: discretionary accruals, average accruals quality, historical accounting restatements, and earnings persistence. Our results are robust to the inclusion of firm characteristics that proxy for difficulty in accrual estimation, known determinants of material weaknesses, and corrections for self-selection bias.

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