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AN EXAMINATION OF THE DETERMINANTS AND CONTENTS OF CORPORATE VOLUNTARY DISCLOSURE OF MANAGEMENT'S RESPONSIBILITIES FOR FINANCIAL REPORTING

by

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ABSTRACT

The Sarbanes-Oxley Act (S-O Act) of 2002 requires principal officers to certify under oath to the veracity of information contained in SEC filings and opine on the effectiveness of the internal control system. This study examines the determinants and contents of corporate voluntary disclosure of management's responsibilities during the five-year period preceding the S-O Act. We predict that the voluntary disclosure of management's responsibilities for financial information signals certain incentives and characteristics of the reporting firm that are relevant to financial statement users and regulators. Consistent with our predictions, our findings reveal significant differences between issuing and non-issuing firms as to the effectiveness of an individual firm's internal control system, access to capital markets, audit committee characteristics, and ownership structure. An empirical analysis of the contents of these assertions also reveals different areas of emphasis and selectivity by management, which represents an informative link to existing disclosure mandates. The results of this study contribute to our knowledge of management's motivations for voluntary disclosure and lend credence to the mandatory certification requirements and related disclosure reforms established in the post-Enron era.

1. INTRODUCTION

The Sarbanes-Oxley Act (S-O Act) of 2002 requires the principal executive and financial officers of each publicly owned company to certify the veracity of information contained in SEC filings and opine on the effectiveness of the internal control system. The Section 302 quarterly certifications require a number of assertions by CEOs and CFOs, including a requirement to report on the effectiveness of the design and operation of the company's disclosure controls, their responsibilities thereon, and to report significant deficiencies and material weaknesses in controls to the external auditor and audit committee. Likewise, Section 404 requires senior executives to report annually on their responsibilities for and effectiveness of the company's internal controls and procedures and disclose any material weaknesses.

The S-O legislation was preceded by a protracted and contentious debate over the benefits and ramifications of disclosures concerning management's responsibilities for financial reporting. For almost 30 years, formal reporting remained non-mandatory, but senior management at many publicly traded companies had voluntarily published a "Report of Management's Responsibility" (RMR)[1] in annual shareholder reports. This study analyzes the determinants of corporate voluntary disclosure of RMRs prior to the S-O Act and examines management's assertions disclosed in those voluntary RMRs.[2] Our findings serve as an informative "bridge" between these two eras and provide additional insights into the ongoing debate of mandatory versus voluntary disclosure. Indeed, a recent study by Financial Executives International (FEI 2005) of Section 404 disclosures reported "considerable variation in management's reports" (p. 5), and that "many firms added specific *voluntary disclosures* about internal control and ethics initiatives" (p.19). Also, the SEC's "Advisory Committee on Smaller Public Companies" (Advisory Committee 2006, pp.6-7) has recommended a "tiered approach" to Section 404 reporting that would partially or totally exempt certain smaller public companies (based on market capitalization) from these requirements.[3]

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[1] Other titles used to describe these disclosures include "Report of Management," "Management Report on Financial Statements," and "Management's Responsibility for Financial Reporting." In this study, the abbreviation "RMR" is used.

[2] Our tests focus primarily on characteristics of firms using RMRs as a disclosure policy. However, to gain more insights into management's incentives to issue an RMR, we also identify and analyze a subset of first-time issuers. Anecdotal evidence and conversations with several chief executive officers and audit partners reveal that the decision to issue an RMR emanates from management, although consultation with the company's auditors and lawyers is not uncommon.

[3] The Advisory Committee was formed by the SEC in March 2005 in order to examine the burdens on smaller public companies resulting from U.S. securities laws (particularly those related to the S-O Act) and to propose solutions to these concerns (Advisory Committee 2006, p.1).

Investors and accounting policy regulators demand relevant and reliable information from public firms that is useful in making rational investment decisions. In satisfying investors' needs for information, firms tend to disclose the minimum-required information, with voluntary disclosures provided on a cost-benefit basis. Accordingly, the voluntary disclosure of an RMR signals certain characteristics and incentives of the reporting firm. These characteristics and incentives shape the content and nature of management's assertions when publicly declaring its responsibilities to the users of financial statements as well as regulators. Since RMRs usually include management assertions on the firm's internal control effectiveness, audit committee, and external auditor, issuing an RMR provides users of financial statements with an additional tool in assessing the credibility and transparency of the firm's reported accounting information.

Exploring the characteristics and incentives of firms that provide voluntary disclosure of management responsibilities for financial reporting enhances users' understanding of an entity's reporting strategy and presents users with additional information to consider in assessing the accuracy and completeness of such financial disclosures. We predict that management's decision to voluntarily issue an RMR is influenced by a number of factors, including effective internal controls, profitability, corporate governance structure, and access to capital markets. An effective internal control system provides assurances for adherence to established operating and financial policies, thereby reducing the likelihood of errors and fraud. Therefore, firms with effective internal controls are less likely to restate their financials or face SEC enforcement actions, and thus are more likely to issue an RMR.

Consistent with prior research (e.g., Abbott et al. 2000; Beasley et al. 2000), we also recognize that effective governance mechanisms, such as independent and active audit committees, are essential ingredients for effective internal controls and operating systems. Accordingly, we predict that audit committees dominated by outside members and that meet frequently can positively influence executives' confidence in the financial statements and their willingness to opine on them. To reduce investors' concern for information asymmetry, firms with extensive need for external financing have more incentives to provide expanded disclosures. Therefore, we predict that firms with frequent issuances of debt and equity capital are more likely to issue an RMR. We also predict that the issuance of an RMR is associated with a firm's profitability and ownership structure.

Consistent with our predictions, univariate tests disclose differences between RMR issuers and non-issuers as to the effectiveness of the firm's internal control system, access to capital markets, audit committee characteristics, and ownership structure. The logistic regression results also support several of the predictions. Management's decision to issue an RMR is associated with the effectiveness of a firm's internal controls, where RMR firms have a lower probability of financial fraud relative to non-RMR firms. Our findings also show the decision to issue an RMR is positively related to the frequency of debt issuance, confirming the prediction that reporting firms use RMRs to signal transparency in their financial reporting to market participants. The results also indicate that corporate governance structure, in particular the presence of an active and independent audit committee, has a positive effect on management's decision to issue an RMR. Additional analysis on a sub-sample of first-time issuers produced results consistent with the above findings.

Our second set of tests in the paper focuses on an empirical analysis of RMR content among issuing firms. The findings reveal different areas of emphasis on assertions by senior management. Although almost all reporting firms (92%) assert that management is responsible for the preparation and integrity of financial statements, only 36% acknowledge management's responsibility for the system of internal controls. As important, only 41% expressed an opinion on the effectiveness of the internal control system and only 24% included discussions of the inherent limitations of internal controls. Cross-sectional analysis among issuers reveals that firm-specific RMR assertions are influenced by profitability, leverage, and audit committee independence.

The study holds interesting implications for policymakers and individual users of financial statements. From a policy standpoint, the study provides empirical evidence to inform the ongoing debate on whether financial disclosure could be left to firm-specific (voluntary) incentives or subject to mandatory regulation. Noting that mandated disclosures may not be necessary, Kothari (2001) argues that a firm can achieve an optimal level of firm disclosure by trading off the costs and benefits of the disclosures they are willing to make. Others have argued that investors need some basic information if they are to exercise their rights and, thus, mandatory disclosure requirements ought to be a primary feature of well-developed capital markets (La Porta et al. 2000).

The findings of this study suggest that the willingness of firms to issue RMRs and the level and nature of assertions made may indeed signal management's uncertainty or concerns over certain financial reporting or internal control matters. In this instance, the data seem to be consistent with the requirement for the uniform certifications by public companies under the S-O Act. Additionally, the results of the study shed light on the firm-specific environment in which the new certification provisions can better achieve their objectives.

2. EMPIRICAL PREDICTIONS CONCERNING RMR ISSUERS

2.1 Effective Internal Controls

RMRs reveal important information concerning the completeness and accuracy of financial information and provide insight into the components and effectiveness of a company's internal control structure. Accordingly, these voluntary assertions expose management to a higher level of accountability for the financial statements and related disclosures. In order to credibly make such assertions, top management must rely on the quality and strength of the company's internal control structure.[4] Kinney (2000), Krishnan (2005) and other researchers discuss the demand and
importance of quality internal controls but acknowledge difficulty (prior to the S-O Act) in assessing such information without formal reporting by companies.

[4] Prior research (Carcello et al. 2002; McMullen 1996) as well as the U.S. Auditing Standards (AICPA 1999, AU Section 319) acknowledges that larger entities are more likely than smaller firms to possess elements of effective internal controls such as a written code of conduct, written policy manuals, an appropriate segregation of duties, and an internal audit function. In addition, accounting disclosure regulators (FASB, SEC) are also sensitive to the burdens and associated costs of increased disclosure on smaller firms (Lang and Lundholm 1993). However, since our sample reflects a matched-pair design by size, the size effect is common to all tested firms.

Like Krishnan (2005), we use a firm's restatement of its financial statements and SEC enforcement actions as a measure of internal control effectiveness. Based on this argument, it is more likely that RMR firms will have fewer financial statement restatements and fewer SEC enforcement actions.

2.2 Profitability

Though research exploring the relationship between firm performance and disclosure has displayed mixed results and may be situation specific, management may "tend to be more forthcoming when the firm is performing well than when it is performing poorly" (Lang and Lundholm 1993, pp.248-249). Proponents of RMRs contend that such disclosures reflect favorably on management's successful stewardship over the firm and are a positive signal to investors and other parties that maintain a contractual relationship with the firm (Kinney 2000; Willis and Lightle 2000). Accordingly, executives of profitable firms may have a higher propensity for issuing an RMR to signal their organizational success and enhance their reputation as effective stewards.

In contrast, one may argue that if managers use RMRs to provide such signals, firms with lower profitability may have greater incentives to do so to reduce investor uncertainty by clarifying their operating policies and processes. This later argument is consistent with a negative relationship between the issuance of RMRs and profitability. Since these arguments suggest that there are competing profitability motives for the issuance of an RMR, this paper attempts to determine the underlying relationship between profitability and the issuance of an RMR with no directional prediction.

2.3 Asymmetry of Information and Cost of Capital

Management possesses better access to knowledge concerning the firm's financial position and performance than outsiders do. Further, firms with limited internal financing and unable to avail themselves of low-cost external financing may be forced to forgo profitable investment opportunities. Therefore, extant theory predicts that firms that plan to tap the capital markets have an incentive to provide voluntary disclosures to reduce information asymmetry and reduce the firm's cost of external financing (Aboody et al. 2004; Healy and Palepu 2001). Sengupta (1998) adds that higher disclosure quality may reduce a lender's perception of default risk, thereby lowering the yield on debt. The quality or "informativeness" of disclosures can also lead to broader coverage by analysts and a lower overall cost of borrowing (Lang and Lundholm 1996). Lastly, firms that periodically enter the capital markets for financing are subject to scrutiny by rating agencies and other interested parties.

Management's assertions concerning financial information, internal control effectiveness, corporate governance and interaction with external auditors are vital to users of financial statements and regulators. Therefore, confident chief executives are more likely to disclose these important assertions in order to signal the reliability of reported information and possibly raise capital at lower cost. This argument leads to the following predictions: RMR firms are more

highly leveraged, issue debt and equity capital more frequently, and are likely to exhibit a lower cost of debt financing than other firms.

2.4 Corporate Governance

The audit committee is the conduit that enables the board of directors to perform its oversight function with respect to accurate and reliable financial reporting, and serves as a critical link between the board, top management, external auditors, and the internal audit function. Fama and Jensen (1983, p.19) posit that outside or independent board members are likely to be more effective in mitigating conflicts between managers and shareholders due to the "separation of top-level decision management and [decision] control," and also face reputation risks as prominent business leaders.

Empirical studies (Beasley et al. 2000; Beasley 1996; McMullen and Raghunandan 1996a) have disclosed that companies with financial reporting problems are less likely to have an audit committee dominated by outside directors, and few meet more than three times per year. Similarly, Beasley et al. (1999, pp.16-17) find that only 38 percent of firms experiencing fraudulent financial reporting during 1987-1997 had audit committees comprised entirely of outside directors and that most averaged approximately two meetings per year. Prior research has also shown that audit committees that meet more frequently and are comprised of non-employee directors can deter the use of aggressive accounting practices by management (Abbott et al. 2000; Parker 1999). Given this discussion, we posit that independent[5] and active[6] audit committees are likely to present an acute influence over senior management's decision to publish an RMR.

2.5 Other Factors

The literature on corporate policy decisions indicates that ownership structure is a significant determinant of voluntary disclosure decisions by firms. Different classes of owners exercise disparate roles in monitoring corporate policies and decisions. For instance, Jensen and Meckling (1976, p.67) suggest that institutional investors and those "who possess comparative advantages in these activities" are likely to be important monitors of management's behavior. As investors, institutional owners face a fiduciary responsibility over the funds provided by individuals and often undertake an active role in monitoring management's performance. Accordingly, a higher concentration of institutional ownership in a particular firm is likely to motivate management to provide additional voluntary disclosures in order to maintain investor confidence (El-Gazzar 1998). Bushee and Noe (2000) also comment that institutional owners

[5] In this study, characteristics that delineate "independent" versus "inside" directors follow the criteria used by Beasley et al. (1999). In that study (p.16), an independent director was defined as one with "no disclosed relationship (other than stock ownership) between the director and the company or its officers." Conversely (p.16), inside or affiliated directors include current or former officers and employees, consultants, those related to management, and those associated with major suppliers, customers, or creditors of the firm.

[6] Recent audit committee recommendations (Business Roundtable 2005, p.20; Blue Ribbon Committee 1999) suggest that a higher frequency of meetings (at least four or more) is necessary to improve effectiveness and enhance oversight responsibilities.

are "sensitive" to disclosure if such information serves to reduce the volatility of stock prices, enhances profitable trading opportunities, and offers additional insight into corporate governance practices. Based on this argument, we predict a positive relationship between the magnitude of institutional ownership of a company and senior management's tendency to voluntarily issue an RMR.

Jensen and Meckling (1976) also assert that higher firm ownership by management narrows the divergence between its interests and those of outside owners. This closer alignment may relax senior management's need to signal the fulfillment of its stewardship role to outside owners. Accordingly, senior management at firms with higher levels of equity ownership by management (e.g., officers, directors, and other defined individuals) are less likely to offer voluntary information above that which is mandatory. This discussion is consistent with a negative relationship between the magnitude of managerial ownership of a company and senior management's tendency to voluntarily issue an RMR.

3. RESEARCH DESIGN

3.1 Sample and Data

To test the above predictions, this study uses a total random sample of 500 firms, distributed as 100 firms per year for the period 1996 to 2000, from the population of companies annually surveyed in the AICPA's *Accounting Trends and Techniques* (*ATT*). *ATT* provides a supplemental classification of firms regarding their reporting on RMRs, which is fundamental to conduct the current research.[7] The base sample was then screened against the following criteria: (1) data availability in COMPUSTAT; (2) completeness of data on audit committees' structure and meetings; (3) confounding events including mergers and acquisitions, and (4) repeated companies. Panel A of Table 1 presents the sample selection and elimination process. From the screened sample, 192 firms were identified as RMR issuers.

To alleviate a possible *ATT* membership bias towards large firms in our treatment sample, we matched the RMR issuers to a control sample of non-RMR issuers based on size, industry, and year from the general population of *ATT* and COMPUSTAT firms. We were unable to obtain this three-dimensional match for 14 companies. Thus, our final matched-pairs sample consists of 178 companies, as shown in Panel B of Table 1. Although our tests focus primarily on characteristics of firms using RMRs as a disclosure policy, we identify 24 first-time issuers from our sample. Additional analysis was then conducted on these first-time issuers to learn more about management incentives in issuing an RMR.

[7] The *ATT* population includes a broad representation of industrial and service firms of diverse size from over 40 industries. It also excludes banks, insurance firms, utilities and other sectors that possess unique financial characteristics or are subject to particular regulatory influences or incentives.

TABLE 1
Summary of Sample Selection and Classification

Panel A: Sample Reconciliation		Number of Firms
Base sample (1996 – 2000)		500
Sample Eliminations:		
1. Insufficient annual data from *COMPUSTAT* for the measuring variables	37	
2. Missing audit committee information and other data due to mergers and acquisitions	23	
3. Extreme observations	16	
4. Repeated firms	103	(179)
5. Non-Issuing firms		(129)
Issuing Firms		**192**

Panel B: Matched Pairs (Size, Industry, and Year)	
Issuing firms	192
Less: Firms with no match	(14)
Matched-pairs: Issuing Firms	178
Matched-pairs: Non-Issuing Firms	178
Final Sample	**356**
First Time Adopters	**24**

3.2 Model

We employ two regression models to test our predictions. First, the logistic regression[8] model (1) below is used to examine the influence of firm-specific characteristics on senior management's decision to issue an RMR. Second, the OLS regression model (2) below is used to examine the relationship between the content (assertions) reported in RMRs and the explanatory variables, including company size.

[8] Logistic regression is appropriate for this portion of the study due to the binary nature of the dependent variable. For each observation, senior management either issues an RMR or not. Essentially, logistic regression estimates the probability of this discrete decision given an array of explanatory variables (Hair et al. 1998, pp. 276-277).

$$RMR_i = \beta_0 + \beta 1\, ICEFF_i + \beta 2\, ROA_i + \beta_3\, FREQD_i + \beta_4\, FREQS_i + \beta_5\, LTDE_i + \beta_6\, AINT_i + \beta_7\, AUDIND_i + \beta_8\, AUDMET_i + \beta 9\, INSTIT\%_i + \beta_{10}\, MANAG\%_i + \varepsilon_i \quad (1)$$

$$CONT_i = \beta_0 + \beta 1\, ICEFF_i + \beta 2\, ROA_i + \beta_3\, FREQD_i + \beta_4\, FREQS_i + \beta_5\, LTDE_i + \beta_6\, AINT_i + \beta_7\, AUDIND_i + \beta_8\, AUDMET_i + \beta 9\, INSTIT\%_i + \beta_{10}\, MANAG\%_i + \beta_{11}\, SIZE_i + \varepsilon_i \quad (2)$$

3.3 Definitions of Variables [9]

The measuring variables in models (1) and (2) above are defined below.

Variable	Description
Dependent:	
RMR	***Report of Management's Responsibility.*** This is a dichotomous variable that represents senior management's disclosure decision. RMR takes the value of 1 for firms that voluntarily reported on their responsibilities and 0 otherwise.
CONT	***Content of RMR Assertions.*** We developed a disclosure index based upon the content of the firm's RMR using an index of 30 assertions commonly found in such disclosures (see Table 5). CONT represents each firm's actual number of assertions disclosed divided by the maximum number in the index. $CONT_i = \sum$ of Firm i's assertions / Maximum Number of Assertions in the Index.
Independent:	
ICEFF	A dummy variable where 1 represents a firm with a financial statement restatement or an SEC Enforcement Action, and 0 if not.
ROA	A three-year average of the Return on Assets calculated as follows: $ROA = \sum_{t=-2}^{t=0} \frac{\text{Net Income (continuing operations)} + \text{Interest Expense (after-tax)}}{\text{Total Assets}}$
FREQD	Number of new public debt issues in the test period (1996 to 2000).
FREQS	Number of new equity issues in the test period (1996 to 2000).
LTDE	Total long-term debt/stockholders' equity at year-end.

[9] Data to calculate ROA, LTDE, AINT and SIZE was extracted from the COMPUSTAT database. Data for AUDIND and AUDMET were collected from the examination of annual proxy statements. Ownership percentages for INSTIT% and MANAG% were retrieved from *Compact Disclosure.* ICEFF was identified from the COMPUSTAT and SEC databases. FREQD and FREQS were obtained from Moody's debt and equity records of new issues for the period of study.

AINT	The average interest rate on the firm's outstanding debt.
AUDIND	The percentage of independent to total audit committee members, where independence is defined as external members with no disclosed financial relationship (other than equity ownership) or employment with the firm.
AUDMET	A dummy variable where 1 represents a firm with at least three audit committee meetings during the year, and 0 if not. We use audit committee activity as a proxy for effectiveness.[10]
INSTIT%	The percentage of voting shares owned by institutional owners at year-end.
MANAG%	The percentage of voting shares owned by management such as officers, directors, and other defined individuals at year-end.
SIZE	The natural log of total assets (in millions) at year-end.

4. EMPIRICAL RESULTS

4.1 Descriptive Statistics

Panel A of Table 2 presents descriptive statistics of the measuring variables for the total sample and the partitioned sample for RMR issuers and non-issuers. Univariate tests of the differences in means are also presented and indicate clear demarcations between the two groups. RMR firms have on average a lower percentage of restatements of financial reports and SEC enforcement actions ($p<0.05$), providing support for our prediction concerning internal control effectiveness. Although not statistically significant, the profitability variable (ROA: return on assets) shows that the average net income per dollar of assets for reporting firms (.069) is higher than for the non-RMR firms (0.062). The surrogates for capital market access and information asymmetry indicate that RMR firms issue public debt (FREQD) and equity (FREQS) more frequently ($p<0.01$ and $p<0.05$, respectively) than non-RMR firms and have higher leverage (LTDE); although the latter variable is not significant. This is consistent with our prediction that firms issue RMRs to signal the credibility of reported information for investors, thereby reducing information asymmetry in the marketplace.

With respect to corporate governance, audit committee independence (AUDIND) and audit committee effectiveness (AUDMET) show that RMR issuers have a higher percentage of outside directors and meet more frequently than those of non-issuers, both statistically significant at $p<0.01$. The statistics on ownership structure disclose that RMR issuers have a greater percentage of equity owned by institutional investors (INSTIT%) but a lower percentage owned by management (MANAG%), both statistically significant at $p<0.01$. This result is consistent with the expectation that institutional investors exercise greater monitoring over investees, causing management to expand disclosure for stockholders.

[10] Prior research involving audit committee activity (e.g., Abbott et al. 2000; Parker 1999; Beasley et al. 1999) suggests that a threshold of at least three meetings per year was necessary during this time period for an audit committee to be deemed minimally effective. In this study, we use this threshold to delineate effective (i.e., active) from ineffective audit committees.

As a sensitivity check, additional analysis of RMR first-time adopters was conducted. The results, as reported in Panel B of Table 2, confirm the effects of internal control effectiveness, access to capital markets, and corporate governance on management's decision to issue an RMR. We find that first-time issuers have, on average, lower instances of restatements of financial statements or SEC enforcement actions (ICEFF). First time RMR firms also exhibit a higher frequency of public debt issuance (FREQD), more audit committee meetings (AUDMET), and a lower average interest rate on debt (AINT) than their matched non-RMR firms.

The correlation matrix in Table 3 reveals low to moderate correlation between the explanatory variables. A review of the Variance Inflation Factor for each variable reveals no significant multicollinearity.

TABLE 2
Descriptive Statistics of the Independent Variables and Group Differences

Panel A: Total Sample, RMR Issuers and Non-Issuers

Variable	Group	Mean	Standard Deviation	25th Percentile	50th Percentile	75% Percentile	Group Difference: Issuers – Non-Issuers Z-Value [(a)]
ICEFF	All	0.17	0.38	0.00	0.00	0.00	
	Issuers	0.14	0.35	0.00	0.00	0.00	-1.67 **
	Non-Issuers	0.21	0.41	0.00	0.00	0.00	
ROA	All	0.066	0.049	0.040	0.061	0.089	
	Issuers	0.069	0.051	0.043	0.067	0.092	1.49
	Non-Issuers	0.062	0.047	0.033	0.057	0.085	
FREQD	All	0.60	0.87	0.00	0.00	1.00	
	Issuers	0.78	0.98	0.00	0.00	1.00	4.10 ***
	Non-Issuers	0.41	0.71	0.00	0.00	1.00	
FREQS	All	1.17	1.86	0.00	0.00	2.00	
	Issuers	1.39	2.06	0.00	0.00	3.00	2.17 **
	Non-Issuers	0.96	1.61	0.00	0.00	2.00	
LTDE	All	0.81	0.88	0.27	0.54	1.05	
	Issuers	0.84	0.94	0.31	0.55	1.05	0.63
	Non-Issuers	0.78	0.81	0.20	0.52	1.04	
AINT	All	0.08	0.04	0.06	0.07	0.09	
	Issuers	0.07	0.03	0.06	0.07	0.09	-0.59
	Non-Issuers	0.08	0.05	0.05	0.07	0.09	
AUDIND	All	0.85	0.24	0.75	1.00	1.00	
	Issuers	0.89	0.16	0.75	1.00	1.00	3.35 ***
	Non-Issuers	0.81	0.30	0.67	1.00	1.00	
AUDMET	All	0.69	0.46	0.00	1.00	1.00	
	Issuers	0.79	0.41	1.00	1.00	1.00	4.02 ***
	Non-Issuers	0.60	0.49	0.00	1.00	1.00	
INSTIT%	All	0.58	0.23	0.45	0.62	0.76	
	Issuers	0.61	0.20	0.53	0.66	0.76	2.88 ***
	Non-Issuers	0.55	0.25	0.39	0.59	0.75	
MANAG%	All	0.09	0.20	0.01	0.02	0.08	
	Issuers	0.06	0.14	0.00	0.01	0.04	-3.32 ***
	Non-Issuers	0.13	0.23	0.01	0.03	0.13	

TABLE 2 *(continued)*

Panel B: First Time RMR Issuers and Matched Sample of Non-Issuers

	First-Time RMR Issuers (N=24)			Matched Sample: Non-Issuers (N=24)			
Variable	Mean	Standard Deviation	Median	Mean	Standard Deviation	Median	Group Difference: Z-Value [a]
ICEFF	0.08	0.28	0.00	0.21	0.41	0.00	-1.24 *
ROA	0.073	0.039	0.063	0.060	0.039	0.063	1.13
FREQD	1.13	1.15	1.00	0.29	0.55	0.00	3.19 ***
FREQS	1.75	1.59	2.00	1.50	1.91	0.00	0.49
LTDE	0.68	0.58	0.55	0.66	0.79	0.38	0.03
AINT	0.06	0.03	0.07	0.09	0.08	0.07	-1.30 *
AUDIND	0.89	0.21	1.00	0.81	0.28	1.00	1.17
AUDMET	0.79	0.41	1.00	0.50	0.51	0.50	2.09 **
INSTIT%	0.67	0.19	0.67	0.60	0.23	0.63	1.04
MANAG%	0.12	0.20	0.02	0.09	0.17	0.02	0.62

(a) *, **, *** Significant at $p < 0.10$, $p < 0.05$ and $p < 0.01$, respectively. (ROA is based on a two-tailed test). Group differences in means for continuous variables are based on t-tests. The between-group differences in location for the binary variables ICEFF and AUDMET are based upon the Wilcoxon Rank-Sum Test.
See Section 3.3 for variable definitions.

TABLE 3
Pearson Pairwise Correlations of the Independent Variables
N = 356

	ICEFF	ROA	FREQD	FREQS	LTDE	AINT	AUDIND	AUDMET	INSTIT%	MANAG%
ICEFF	1.00									
ROA	-0.03	1.00								
FREQD	0.03	-0.01	1.00							
FREQS	0.02	0.02	0.10*	1.00						
LTDE	0.04	-0.24**	0.02	0.03	1.00					
AINT	-0.03	-0.07	-0.03	0.01	0.01	1.00				
AUDIND	0.05	0.11*	0.07	0.03	0.01	-0.10	1.00			
AUDMET	-0.02	0.02	0.13*	0.08	-0.01	-0.04	0.28**	1.00		
INSTIT%	0.06	0.15**	0.17**	0.06	-0.03	-0.03	0.31**	0.25**	1.00	
MANAG%	-0.10*	-0.04	-0.14**	-0.09	0.03	0.04	-0.33**	-0.24**	-0.45**	1.00

*, ** Pearson correlation coefficients are significant at $p < 0.05$ and $p < 0.01$, respectively (two-tailed)
See Section 3.3 for variable definitions.

4.2 Results of the Logit Model

This section analyzes the results of the Logit multiple regression model and presents statistics on the relative influence of each factor in management's decision on RMRs. Table 4 presents the coefficient estimates of regressing management's decision to issue RMRs against the explanatory variables. Results are presented separately for the total sample (356 firms) and first-time adopters (48 firms).

TABLE 4
Logistic Regression Coefficients of the Explanatory Variables on RMR Issuance

		Coefficient (Chi-square)	
Variable	Expected Sign	Total Sample	First-Time Issuers
Intercept	?	-1.79 (7.74) ***	-0.82 (0.08)
ICEFF	-	-0.63 (4.33) **	-0.01 (0.01)
ROA	+/-	3.42 (1.93)	14.48 (0.61)
FREQD	+	0.45 (10.09) ***	1.26 (3.94) **
FREQS	+	0.09 (2.20)	-0.09 (0.14)
LTDE	+	0.13 (0.87)	0.07 (0.01)
AINT	-	-0.45 (0.03)	-7.18 (0.51)
AUDIND	+	0.97 (3.09) *	0.05 (0.01)
AUDMET	+	0.65 (6.21) ***	2.05 (4.70) **
INSTIT%	+	0.11 (0.03)	-1.76 (0.39)
MANAG%	-	-1.31 (2.74) *	-0.35 (0.01)
F Statistic		47.68 ***	20.04 **
Pseudo R^2		12%	35%
Sample size		356 firms	48 firms

The Wald (Chi-square) statistic is indicated in parentheses
*, **, *** Coefficient statistically significant at $p < 0.10$, $p < 0.05$ and $p < 0.01$, respectively. (ROA is based on a two-tailed test).
See Section 3.3 for variable definitions.

The results for the total sample in Table 4 show that the coefficient of the internal control effectiveness (ICEFF) is negative and significant ($p<0.05$), suggesting that RMR firms are likely to experience fewer incidences of financial fraud or disclosure violations. This reinforces the inference that RMR firms have more effective internal control systems. The coefficient of profitability (ROA) is positive but insignificant, suggesting profitability is not an influencing factor in management's policy to issue RMRs. The effect of a firm's frequent issuance of public debt (FREQD) on management's policy to issue an RMR is positive and significant ($p<0.01$), supporting the inference that through RMRs firms attempt to reduce investors' concerns for information asymmetry.

The results of the audit committee variables support the expected corporate governance relationships. The coefficients for audit committee independence (AUDIND) and effectiveness (AUDMET) are both positive and statistically significant at $p<0.10$ and $p<0.01$, respectively, confirming the direct influence of monitoring on management's RMR decision. The coefficient of debt financing (LTDE) has the expected positive sign but lacks statistical significance. The ownership structure variables (INSTIT% and MANAG%) have the expected sign, and the latter is significant at $p<0.10$.[11]

For the first-time adopters, the results in Table 4 show that the coefficients for FREQD and AUDMET are positive and statistically significant at $p<0.05$. These findings confirm the influences of public debt issuance and audit committee effectiveness on management's initial decision to issue an RMR. All of the other variables except for FREQS and INSTIT% are in the expected direction. The results are largely consistent with those for the total sample.

4.3 RMR Assertions

The second objective of this paper is to analyze the contents of the voluntarily-issued RMR. It is of great interest to regulators and users of financial statements to understand management's assertions and whether or not they are common across firms. We developed an RMR content index of 30 assertions (equally weighted) based on prior recommendations set forth by the Cohen Commission (1978), Treadway Commission (1987), the Committee of Sponsoring Organizations (COSO 1992), and existing practice. Extending prior studies, (e.g., Willis and Lightle 2000; McMullen et al. 1996b), we analyzed each of the 192 RMRs in our sample and classified management's assertions into the following five categories: *responsibility for financial statements, system of internal controls (and elements), corporate governance, independent auditors, and signatures of senior officers.* Table 5 lists the coding and frequency results of management assertions found in the sample.

[11] To examine the effect of auditing firm "quality" on management's RMR decision, an analysis of the sample firms revealed that over 85% were audited by Big 5 firms. No further analysis was necessary to examine this additional factor.

TABLE 5
Management Assertions and Frequency in Voluntarily-Issued RMRs (N=192)

	Assertions by Category	Index
	Financial Statements	
1.	Management is responsible for the preparation/integrity of the financial statements	**92%**
2.	The financial statements have been prepared in accordance with GAAP	**97%**
3.	The financial statements include estimates and the judgment of management	**90%**
4.	Management is responsible for the "other" financial information	**60%**
5.	The "other" financial information is consistent with the financial statements	**29%**
6.	Representations by management are valid and appropriate	**4%**
	System of Internal Controls	
7.	Management is responsible for (or maintains) the system of internal controls	**36%**
	The purpose of the internal control system:	
8.	• Safeguard assets	**85%**
9.	• Execute transactions in accordance with management's authorization	**50%**
10.	• Prepare reliable financial information	**83%**
11.	Inherent limitations in internal controls (reasonable assurance, cost/benefits)	**24%**
12.	Other limitations in the internal control system (errors, oversight, etc.)	**8%**
	Elements of the internal control system:	
13.	• Appropriate segregation of duties or division of responsibilities	**31%**
14.	• Established guidelines, policies and procedures	**52%**
15.	• Code of professional conduct/improve ethical climate	**30%**
16.	• Careful selection and training of personnel	**44%**
17.	• Monitored by the internal auditing function	**79%**
	Other Commentary on Internal Controls:	
18.	• Actions are taken to correct control deficiencies or enhance the system	**21%**
19.	• An opinion as to the reliability/effectiveness internal controls	**41%**
20.	• Criteria used (e.g., COSO Report) to assess effectiveness of controls	**1%**
	Corporate Governance	
21.	An Audit Committee exists	**96%**
22.	The Audit Committee consists entirely of members who are independent (not officers or employees) of the entity	**89%**
23.	A discussion of the Audit Committee's role and/or activities (oversight over management and/or financial reporting)	**96%**
24.	The independent auditors are recommended by the Audit Committee and/or approved by shareholders	**34%**
	Independent Auditors	
25.	An independent accounting firm has audited the financial statements	**84%**
26.	The auditors have ready access to the Audit Committee	**65%**
27.	The audit was conducted in accordance with generally accepted auditing standards	**40%**
28.	The internal control system was reviewed during the performance of the audit	**40%**
	Signed by Senior Management	
29.	• Chairman of the Board, Vice Chair, Chief Executive Officer, or President	**68%**
30.	• CFO, Chief Accounting Officer, or other senior officer	**80%**

From Table 5, the heterogeneity and selectivity of the assertions disclosed by management are apparent. For instance, almost all firms (92%) stated that management is responsible for the financial statements and 97% stated that they have been prepared in accordance with generally accepted accounting principles. Yet, only 36% of the sample firms acknowledged management's responsibility for the system of internal controls, only 24% discussed the inherent limitations in the system, and 21% mentioned that actions were taken to correct control deficiencies or enhance the system.

The results in Table 5 indicate that firms are very selective in the type of voluntary disclosures made in the RMR. In each of the disclosure categories, we find that the vast majority of the firms disclose the "general assertions," with the specific and/or detailed assertions provided with lower frequency. For instance, in the financial statement category, 90% of the firms stated that financial statements include estimates and judgments by management, yet only 4% of the firms assert that those judgments and representations are "valid and appropriate" as recommended by the Treadway Commission (1987) and COSO (1992). Furthermore, in the corporate governance category, 96% of the firms report on the presence of the audit committee and 89% on its composition, while only 34% stated that the audit committee recommended the independent auditor.

The diversity in disclosure provides additional insight into the activities and effectiveness of the audit committee's role within the firm and is consistent with recent findings on the variance between responsibilities disclosed in audit committee charters and actual performance (Carcello et al. 2002). This diversity in the voluntary assertions contained in RMRs supports the mandated and uniform certification requirements in the S-O Act as well as recent SEC and stock exchange requirements on corporate governance and expanded disclosure.

To examine the effect of the firm-specific attributes on the actual level of management's assertions, we regressed the content index (CONT) against the explanatory variables of the 192 issuing firms. We also developed a second "internal control content" index based upon the frequencies of management assertions 7 through 20 from Table 5. The results of the OLS regressions in Table 6 show that the influences on each index are consistent with respect to a number of factors. The coefficient for audit committee independence (AUDIND) in both models is positive and statistically significant at $p<0.01$, suggesting that independent audit committee members exert a strong influence on the content of management's assertions as part of their oversight role. Moreover, both models indicate that RMR content is significantly and positively influenced by the degree of leverage (LTDE) and company size (SIZE). Lastly, profitability (ROA) is significantly and positively associated with the overall level of assertions. We ran both models excluding SIZE and found the results (unreported) remain unchanged.

TABLE 6
OLS Estimates of Regressing RMR Contents on the Explanatory Variables (N=192)

Variable	Expected Sign	Coefficient (t-value) of Disclosure Scores: Index of Internal Control Assertions	Coefficient (t-value) of Disclosure Scores: Index of All RMR Assertions
Intercept	?	-0.03	0.16
		(0.32)	(2.57)***
ICEFF	-	0.03	-0.01
		(1.00)	(0.05)
ROA	+/-	0.33	0.43
		(1.48)	(2.83)***
FREQD	+	-0.01	-0.01
		(0.15)	(0.38)
FREQS	+	-0.01	-0.01
		(1.18)	(0.86)
LTDE	+	0.02	0.01
		(2.26)**	(2.17)**
AINT	-	0.42	0.26
		(1.21)	(1.07)
AUDIND	+	0.25	0.22
		(3.73)***	(4.75)***
AUDMET	+	0.01	0.01
		(0.28)	(0.03)
INSTIT%	+	0.01	0.01
		(0.21)	(0.04)
MANAG%	-	0.02	0.07
		(0.26)	(1.19)
SIZE	+/-	0.02	0.02
		(2.16) *	(2.79) ***
F-Statistic		2.95***	4.23***
R^2		15%	20%
Number of Assertions		14	30

t- statistics are indicated in parentheses
*, **, *** Coefficient statistically significant at $p<0.10$, $p < 0.05$ and $p< 0.01$, respectively. (ROA and SIZE are based on two-tailed tests).
See Section 3.3 for variable definitions.

5. SUMMARY AND CONCLUDING REMARKS

For a quarter-century prior to the S-O Act, senior management had discretion in deciding whether to publicly disclose its responsibilities for financial reporting. However, the S-O Act has re-emphasized management's critical role over financial reporting and internal controls and heightened the risks of failure to act in accordance with these responsibilities. This paper examines the characteristics and incentives of firms issuing RMRs as a voluntary disclosure policy and identifies management assertions included therein.

The results of the study show that RMR issuing firms are less likely to restate their financial reports and/or face SEC enforcement actions. These measures validate the positive influence of the company's internal control effectiveness on management's decision to voluntarily issue an RMR. This finding has particular implications for smaller companies as well as non-reporting firms (prior to the S-O Act) where more formal or effective financial reporting and internal control processes may be absent. Indeed, the SEC is currently studying the possibility of relaxing elements of Section 404 reporting for smaller firms and whether or not voluntary disclosure may be sufficient. The findings of the study further confirm the positive influence of the audit committee oversight on management's actions. The results also reveal that firms with frequent issuances of debt are more likely to issue RMRs, suggesting that reporting firms use RMRs to signal the reliability of reported information, thereby reducing investors' information asymmetry.

The analysis of the contents of the sample RMRs indicates management's tendency towards voluntary disclosure of "general" assertions in delineating its responsibilities for financial information. However, firms are averse to disclosure of specific assertions such as deficiencies within the internal control system, the effectiveness of the system, and whether the audit committee recommended the external auditor. Variations in these assertions in a given RMR are also influenced by a number of firm-specific attributes such as company size, profitability, audit committee independence and degree of leverage.

Further research can be expanded to include other special industries such as financial services, utilities, and airlines where particular influences and additional variables are likely required. Additionally, a comparative analysis of the contents of voluntarily reported RMRs and mandated disclosures under the S-O Act would shed further light on the ongoing debate of voluntary versus mandated disclosure.

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