

ARE COMPANIES THAT REPORT MATERIAL WEAKNESSES IN INTERNAL CONTROL MORE LIKELY TO RESTATE THEIR FINANCIAL STATEMENTS?

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ABSTRACT

This study provides empirical evidence on the relationship between reported material weaknesses in internal control and the probability of a company restating its earnings, based on a sample of 518 restating companies and 518 matching companies selected from the period January 1, 2004 through December 31, 2005. First, this study finds a significant relationship between the incidence of material weaknesses reported by the firm and the probability of a firm restating its earnings. Second, the magnitude or frequency of material internal control weaknesses reported by the firm is significantly related to the probability of a firm restating its earnings. The higher the number of material weaknesses reported by a company, the greater the probability that the company will restate. Finally, the type of material internal control weakness is significantly related to the probability of a firm restating its earnings. This study finds that companies reporting material weakness in accounting related areas such as accruals, revenue recognition, period-end closings and accounting policies, and complex areas such as derivative and lease accounting are more likely to restate earnings than those companies reporting material weakness in non-accounting areas such as training, segregation of duties, senior management, and subsidiary specific areas

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