CPA Research Speaker Series (Accounting)

Alberta School of Business
Department of Accounting, Operations, and Information Systems

Presents:

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Topic:

When Does Internal Control over Financial Reporting Curb Resource Extraction?

Evidence from China

Friday, September 22, 2017
2:00pm – 3:30pm
BUS Room 4-04 (CA Conference Room)

ABSTRACT

We examine whether the strength of internal control over financial reporting (internal control) reduces the expropriation of resources from the firm by managers and controlling shareholders. Although we have ample evidence from prior literature that internal controls reduce errors in financial reports, it is less clear that they can curb resource extraction, as management may fail to implement or simply override these controls. We exploit a rich Chinese dataset to distinguish between the design and implementation of internal controls. On average we find some evidence that internal controls curb resource extraction, but further investigation reveals that many firms with documented internal controls fail to implement these controls, or simply override them (i.e., form over substance), and these firms' controls do not curb resource extraction. We find that internal controls are most likely to be form over substance when they are policy driven instead of voluntarily adopted, and also when there are more severe agency problems, and thus an increased likelihood of control override. Although the analysis is conducted with Chinese data, the spirit of our findings should generalize to other settings. In particular, our findings suggest that management can use the "form" of internal control procedures while still engaging in the undesirable behavior.

(Copies of the paper are attached)