Controversial internal control audits improve operational efficiency for small firms, study finds

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The November collapse of cryptocurrency exchange FTX serves as a lesson of what happens when a corporation avoids internal audits of its own financial operations.

A new article examines how such audits often affect firms' operational efficiency—and why these controversial practices are not always performed.

"Regulators keep exempting more firms from complying with internal control audits because of the costs," said Chan Lin, the C.A. Scupin Professor at the University of Kansas School of Business.

"Not only is the cost high, but firms don't feel it has value. They assume since management is doing the internal control evaluation themselves, the auditor opinion does not matter. That's why it's controversial."

Her article, titled "Does the Presence of an Internal Control Audit Affect Firm Operational Efficiency?" observes how auditors' evaluation and report of Internal Control over Financial Reporting (ICFR) affect firm operational efficiency. While prior research indicates the strength of these controls is positively associated with economic benefits, this study finds that small firms with ICFR audits have significantly higher overall efficiency than those with only management ICFR reports. It appears in Contemporary Accounting Research.

Co-written by Andrew Imdieke of the University of Notre Dame and Shan Zhou of the University of Sydney, Li's study is based on a sample of firms with market values less than or equal to $150 million from 2007 to 2019. It compares operational efficiency between firms that have ICFR audits and those that show improved efficiency, after monitoring for internal control quality and firm fixed effects. This also finds improvements are reflected in inventory turnover and corporate innovation.

"We look at the internal control audit and the firm's operational efficiency," Li said.

"Our argument is the managers should rely on the numbers produced from the financial reporting system to make operational decisions. If the numbers generated from the internal financial reporting system is of high quality, then the management relying on that information will make better operational decisions."

The team observed two mechanisms through which the ICFR audit could affect operational efficiency: Auditors detect Internal Control Material Weakness (ICMWs) that would otherwise go unnoticed and auditors provide managers with best practice recommendations to their internal control system during the ICFR evaluation process.

"We also find the positive effect on the operational efficiency is manifested through the increased improvement in inventory turnover and innovation," she said.

Surprisingly, Li determined the internal control audit will decrease the efficacy of SG&A (Selling, General and Administrative Expenses).

"This could partially be attributed to higher audit fees when you have to have an internal control audit," she said.

In 2020, the SEC adopted amendments of the definitions of "accelerated filer" and "large accelerated filed" that exempts a greater number of smaller issuers from complying with Section 404(b) of the Sarbanes-Oxley Act (which requires management of public companies to assess the effectiveness of the internal control of issuers for financial reporting). The new requirements exempt firms with a public float between $75 million and $700 million from internal control audits as long as the firm's revenues are below $100 million.

Her team revealed that exempted firms still realized operation efficiency benefits from their past ICFR audits. Therefore, the removal of the mandate may hinder similar firms from realizing ICFR benefits in the future.

Li earned a doctorate in accounting from KU. She's worked at the university for the last three years, where she specializes in archival auditing, corporate governance and internal control.

"The lesson here is simple: internal audit does have its value," Li said. "So when the regulators exempt more firms from complying with internal control audits, they may adversely affect operational efficiency."

The study is available as a working paper on the *SSRN Electronic Journal* site.

More information: Andy Imdieke et al, Does the Presence of an Internal Control Audit affect Firm Operational Efficiency?, *SSRN Electronic Journal* (2022). DOI: 10.2139/ssrn.3961921

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