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Internal control reporting and accounting standards: A cross-country comparison ☆

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A B S T R A C T

In this study, I examine whether there is a difference between internal control reporting (measured through the presence/absence material weaknesses) among foreign and U.S. firms. I also examine the relation between internal control reporting and the accounting standards used by firms (i.e., U.S. and foreign) in their submitted SEC financial statements. Overall, my results indicate that foreign firms are more likely to report material weaknesses than U.S. firms. Furthermore, foreign firms that submit financial statements that are prepared using U.S. GAAP or prepared using their domestic standards and then reconciled to U.S. GAAP are more likely to report material weaknesses. Since country specific political factors could influence the reporting of material weaknesses I also examine whether rule of law impacts the reporting of material weaknesses. My results indicate that foreign firms that are classified as strong rule of law countries are less likely to report material weaknesses and foreign firms that are classified as weak rule of law countries are more likely to report material weaknesses. Additionally, foreign firms that prepare the SEC submitted financial statements using IFRS are less like to report material weaknesses in strong rule of law countries and there is no significant relation between IFRS firms and material weakness reporting in weak rule of law countries.

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☆ *Data:* Available from the author and the sources identified within the text.

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1. Introduction

In the current study, I use a sample of firms that are listed on the United States (U.S.) stock exchanges to examine the relation between internal control, measured through reported material weaknesses (MW), and both headquarter location (i.e., whether a firm is U.S. based or foreign based) and accounting standards used by foreign firms. Prior research has examined the determinants of reporting internal controls but has not analyzed whether internal control reporting, under SOX, differs among domestic and foreign firms. Additionally, recent prior research has separately examined both the relation between accounting standards and financial reporting quality and the relation between financial reporting quality and internal controls. However, research has not yet examined the relation between accounting standards and internal control. Given the current debate in the U.S. with respect to convergence to a set of global accounting standards and the importance of internal controls within financial reporting, internal control reporting by foreign firms and the relation between internal control and accounting standards is important to regulators and financial statement users as they work to understand how information can be compiled and presented in a transparent and comparable format.

Internal controls and accounting standards are two separate, albeit related, tools used to control and prepare financial information (i.e., internal controls are devised based on a framework that is separate from the accounting standards used by a firm). In relation to financial reporting, internal controls are the processes that have been put in place to ensure reliable financial reporting (COSO, 2013). The two main sets of accounting standards used by most firms worldwide, International Financial Reporting Standards (IFRS) and U.S. Generally Accepted Accounting Principles (U.S. GAAP), are the sets of rules/principles that should be applied to firm information to generate financial reports. Internal controls are applied and used as measures to check and balance the various rules and principles. Thus, if the accounting standards are different between companies, the internal controls that are used to regulate those standards will also be different.

Over the past two decades, the U.S. Securities and Exchange Commission (SEC) and the Financial Accounting Standards Board (FASB) have been discussing, investigating, and implementing accounting standards convergence measures with the International Accounting Standards Board (IASB). However, various shocks to the U.S economy have slowed this convergence process. In a recent address on May, 7, 2015, James Schnurr, the SEC Chief Accountant, stated the following:

> "*while full scale adoption [of IFRS] does not appear to have support, it does not mean we "bury" the underlying objective of a single set of high-quality, globally accepted accounting standards. On the contrary, constituents continue to support that idea*"
>
> [SEC, 2015]

Proponents of IFRS convergence argue that a switch to IFRS, a principles-based system, would allow firms the flexibility to make accounting choices that are tailored to the individualized contexts in which firms from various countries operate (Carmona and Trombetta, 2008).[1] This individualized approach to financial reporting allows for increased comparability (Yip and Young, 2012; Barth et al., 2012). Alternatively, opponents argue that GAAP, a rules-based system, yields greater uniformity through bright-line thresholds for financial reporting standards, and they argue that uniformity results in a higher level of financial reporting quality (Atwood et al., 2011; Lin et al., 2012). However, both proponents and opponents of IFRS recognize that accounting standards are just one factor of many that impact financial reporting (Holthausen, 2009).

In this paper, I utilize a direct measure of internal control reporting (reported material weaknesses) to examine the relation between both internal control reporting and foreign firms as well as internal control reporting and accounting standards. More specifically, I use the SOX mandated internal control management reports to investigate whether internal control reporting differs among domestic (U.S. headquartered firms) and foreign firms. Furthermore I investigate the relation between internal control reporting and accounting standards using three different categories of foreign SEC registrants:

[1] The IFRS foundation reports that, as of May 1, 2015, 116 jurisdictions require IFRS for all or most of their public companies (IFRS, 2015).

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