A Review of Academic Literature on Internal Control Reporting

Arnold Schneider *
Professor
College of Management
Georgia Institute of Technology
800 W. Peachtree St.
Atlanta, GA 30308
Phone: (404) 894-4907
Fax: (404) 894-6030
arnold.schneider@mgt.gatech.edu

Audrey A. Gramling
Associate Professor
Coles College of Business
Kennesaw State University
Kennesaw, GA 30144
agramli1@kennesaw.edu

Dana R. Hermanson
Dinos Eminent Scholar Chair and Professor
Coles College of Business
Kennesaw State University
Kennesaw, GA 30144
dhermans@kennesaw.edu

Zhongxia (Shelly) Ye
Assistant Professor
Coles College of Business
Kennesaw State University
Kennesaw, GA 30144
zye@kennesaw.edu

May 2009

* Corresponding author
A Review of Academic Literature on Internal Control Reporting

In the past three decades, there have been numerous debates about whether companies should provide internal control disclosures and also whether auditors should attest to such disclosures in order to deter management fraud [AICPA, 1978; Public Oversight Board, 1993]. For public companies, the SOX legislation has now made internal control reporting with auditor attestation mandatory in annual 10-K filings.

In this paper, we review the literature on internal control reporting. The primary insights gleaned from our review of the literature are:

- In the pre-SOX voluntary environment, management reporting on ICFR was not common, and auditor attestation was very rare. In instances where management did provide reports, there was a great deal of diversity in the information that was provided, and few companies outside of the Fortune 100 provided any assessment of internal control effectiveness.

- Internal control deficiencies (ICDs) disclosed under SOX often are related to the same financial reporting areas or issues that are present in cases of fraudulent financial reporting, and the profile of accelerated filers disclosing ICDs is consistent with the profile of fraud companies. Sound governance, auditing, and management are critical to the remediation of ICDs.

- Many consequences of ICD disclosures under SOX have been revealed, including lower earnings quality, negative equity market reactions, higher cost of debt and equity, and less accurate earnings forecasts. Experimental researchers have found that ICD disclosures affect individuals’ decisions. Managers have attempted to avoid SOX 404 costs by taking companies private or reducing companies’ market values to achieve or maintain the status of non-accelerated filers.

- In the SOX period, there is evidence that auditors’ internal control judgments can be biased and that ICDs affect the audit process and auditor-client relationships (e.g., auditor changes). Audit fees are higher in the presence of ICDs.

We offer conclusions and recommendations for future research.