Synopsis

The Effect of Internal Control Deficiencies on Firm Risk and Cost of Equity Capital*

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In an attempt to increase investor confidence in financial reporting, the Sarbanes-Oxley Act of 2002 mandates public company management evaluation and an independent audit of internal control effectiveness. The mandate is costly for an issuer to implement, but may benefit the firm through lower information risk which translates into lower cost of equity capital.

In this study, we use unaudited pre-SOX 404 disclosures and SOX 404 auditor opinions on internal control over financial reporting along with the *Value Line* expected returns file to assess how internal control quality affects a firm's risk and cost of equity capital. After controlling for internal control risk factors, we find that issuers reporting internal control deficiencies have significantly higher idiosyncratic risk, systematic risk, and cost of equity capital. Furthermore, we provide evidence that an issuer's remediation of an internal control problem is followed by a significant reduction in the cost of capital.

The estimated effects of internal control deficiencies on cost of equity capital are economically important. In a multivariate regression that controls for idiosyncratic and systematic risk and internal control risk factors, we find that initial deficiency disclosures add an estimated 53.8 basis points (.538%) to issuer's cost of capital. The median cost of capital increase for deficiency firms compared to issuers not reporting deficiencies is 104.2 basis points. Furthermore, when the independent auditor confirms remediation of a material weakness, the median market adjusted cost of capital drops by 131.3 basis points. In contrast, issuers with continuing deficiencies experience no change after auditor confirmation. Finally, even though there is no significant cost of capital change across all issuers that receive "clean" auditor opinions on internal control, a sub sample of "clean opinion" issuers that would be *expected* to receive adverse opinions enjoy a 58.3 basis point median decrease in cost of capital.

Overall, the results of our cross-sectional and change analysis tests are consistent with strong internal controls being valued by the capital market.

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