Economic Determinants and Consequences of the Proactive Disclosure of Internal Control Weaknesses and Remediation Progress in IPOs

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SUMMARY: This study investigates (1) why some IPO firms proactively disclose internal control weaknesses (ICWs) and remediation progress in their prospectuses before going public, despite being exempt from the requirements of Sections 302 and 404 of the Sarbanes-Oxley Act at the time of IPO, and (2) the association of such disclosures with IPO underpricing (i.e., the first-day return). We find that IPO firms that proactively disclose ICWs and remediation progress have higher litigation risk, are audited by industry specialist auditors, and are more likely to have audit committees prior to the IPO, compared with firms that do not disclose such information, after controlling for the antecedent probability of having ICWs. IPO underpricing is lower for firms that disclose ICWs and remediation progress, consistent with the conjecture that the disclosure of ICWs and remediation progress signals extensive premarket due diligence, thus reducing the information asymmetry between informed and uninformed investors.

JEL Classifications: G24; K22; M13; M41; M42; M49.

Keywords: internal control weaknesses; SOX 302; SOX 404; IPO underpricing.

I. INTRODUCTION

The Sarbanes-Oxley Act of 2002 (SOX) mandated several new corporate governance and reporting requirements for publicly traded companies. Sections 302 and 404, which require managers to disclose internal control weaknesses (ICWs) and auditors to attest to the effectiveness of their clients’ internal controls, respectively, have been hotly debated (Hermanson and Ye 2009).1 SOX 404(b) internal control audits were deemed so onerous and costly that the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 permanently exempted non-accelerated filers from its

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1 Section 302 requires the CEO and CFO of companies to provide quarterly certification on the effectiveness of internal control. Section 404 has two parts, 404(a) and 404(b). Section 404(a) requires management of companies to issue annual reports on the effectiveness of their internal control. Section 404(b) requires auditors of companies to express an opinion annually on the effectiveness of their clients’ internal control.