

Does Ineffective Internal Control over Financial Reporting affect a Firm’s Operations? Evidence from Firms’ Inventory Management 🛒

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ABSTRACT

We investigate whether ineffective internal control over financial reporting has implications for firm operations by examining the association between inventory-related material weaknesses in internal control over financial reporting and firms’ inventory management. We find that firms with inventory-related material weaknesses have systematically lower inventory turnover ratios and are more likely to report inventory impairments relative to firms with effective internal control over financial reporting. We also find that inventory turnover rates increase for firms that remediate material weaknesses related to inventory tracking. Remediating firms also experience increases in sales, gross profit, and operating cash flows. Finally, we assess the generalizability of our findings by examining all material weaknesses in internal control over financial reporting, regardless of type, and provide evidence that firms’ returns on assets are associated with both their existence and remediation. Collectively, our findings support the general hypothesis that internal control over financial reporting has an economically significant effect on firm operations.

Keywords: [internal control over financial reporting](#), [inventory management](#), [firm operations](#)

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