THE LONDON SCHOOL OF ECONOMICS AND POLITICAL SCIENCE

Department of Accounting

"Internal Control Weaknesses in the Market for Corporate Control: Disclosure vs. Propensity"

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Abstract

This paper examines how SOX 302/404 disclosures on the internal control environment affect the market for corporate control. Using a sample of (1) acquisitions that involve acquirers and targets that disclosed internal control weaknesses (ICWs) under SOX and (2) acquisitions that do not involve ICW disclosures as matched control samples, we document that ICW-acquirers earn smaller cumulative abnormal returns (CARs) while ICW-targets receive higher CARs than their non-ICW matches around the announcement dates. We also find evidence that acquirers with ICWs pay larger acquisition premia to targets, but targets with ICWs receive smaller acquisition premia. Larger premia are also paid by acquirers with high propensity scores for ICWs (but without ICW disclosures), suggesting higher premia are a behavioural consequence of firm characteristics. Acquisitions are likely to be motivated by empire-building, and top management suffers from hubris. Overall, our results suggest that SOX disclosures on internal controls provide incremental information in evaluating firm value.