Are all Material Control Weaknesses Created Equal? Evidence from the Impact of Information Technology Weaknesses on Analysts’ Forecast Accuracy, Dispersion and Market Returns

Abstract: Information technology (IT) is pivotal in the monitoring of internal controls and has a strong impact on the quality of processing and disseminating of financial information. Thus, material control weaknesses related to IT can have a more pervasive impact on the quality of information resulting from the financial reporting system. We examine two questions related to financial analysts—the direct consumers of information from the financial reporting system: what is the impact of IT material weaknesses on 1) the accuracy and 2) the dispersion of financial analysts’ earnings forecasts. Consistent with our expectations, we find that analysts’ forecasts are less accurate and those forecasts diverge more for IT weakness firms relative to both firms with non-IT weaknesses and non-weakness firms. We also find that risk-adjusted buy-and-hold market returns are significantly lower (by up to 8%) for firms with IT material weaknesses than those returns for non-IT material weaknesses. These results suggest that the market anticipates the negative consequences of internal control weaknesses, but analysts react slowly as they increase their search for private information to improve forecast accuracy. Our study complements and extends extant research highlighting the importance of IT in the financial reporting process.