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The Role of Financing Constraints and Environmental Uncertainty in Limiting the Link between Operational Diversification and the Weakness of Internal Controls

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ABSTRACT

The purpose of this paper is to examine the role of financing constraints and environmental uncertainty in limiting the relationship between operational diversification and weak internal controls. For this purpose, data on 120 stock companies for the period 2007-2017 were extracted and logistic regression was used to test the hypothesis. According to the first hypothesis, product diversification has a significant relationship with weak internal controls. In addition, environmental uncertainty has a significant impact on the relationship between diversification and weak internal controls. Finally, financing constraints do not have a significant effect on the relationship between diversification and weak internal controls.

1-Introduction

Given the organizational complexity of the companies, the agency conflict hypothesis states that, during diversification, managers have the opportunity to engage in nonoperational activities to gain personal interests through decision-making and control. Companies with higher diversification may tend to have ineffective internal controls because strong internal controls emphasize the prevention and discovery of opportunistic activities. Managers have the ability to transfer interests from shareholders to their own through ineffective controls. On the other hand, some managers, with the establishment of internal controls, tend to conceal their opportunism. In this situation, internal controls do not have high quality and effectiveness.

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The opportunistic approach of managers leads to postponing bad news due to weaknesses in performance and the quality of internal controls can be a factor in modifying it. The purpose of this paper is to examine the role of financing constraints and environmental uncertainty in limiting the relationship between operational diversification and the weakness of internal controls.

2- Hypothesis

The purpose of this paper is to examine the role of financing constraints and environmental uncertainty in limiting the relationship between operational diversification and the weakness of internal controls. The primary goal of the research is to examine the effectiveness of diversification on internal controls; then the research progresses to study the direction and quality of the financing constraints and environmental uncertainty effect. Thus, research hypothesis is developed as follows:

H1: *Diversification leads to change in the quality of internal controls.*

H2: *Environmental uncertainty has a significant effect on the joint interaction of operational diversification and the weakness of internal controls.*

H3: *Financing constraints have a significant effect on the joint interaction of operational diversification and the weakness of internal controls.*

3- Methods

The purpose of this study is descriptive and based on the nature and method of correlation. Considering that this research can be used in the decision making process of investors, the type of applied research is considered. In this research, library method has been used to collect data and information. Then, for collecting the research data, compact discs, visual and statistical archives of the Tehran Stock Exchange, the official website of Tehran Stock Exchange and other related online databases have been used.

For this purpose, data on 120 companies listed in Tehran Stock Exchange for the period of 1386 to 1396 were extracted and a logistic regression model was used to test the research hypothesis.

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4- Results

The results of the research indicate that the business units with diversification have weaker internal control quality. In addition, the second hypothesis of the research indicates that environmental uncertainty has a significant effect on the common interaction of diversification and the weakness of internal controls.

Finally, the results indicate that financing constraints have a significant effect on the joint engagement of diversification and the weakness of internal controls.

5- Discussion and Conclusion

In this research, the role of financing limitation and environmental uncertainty in limiting the internal control implications of diversification has been studied. The first hypothesis of the study that diversification has led to a change in the quality of internal controls has been confirmed. The results of this hypothesis are similar to those of Chen and keung (2018). It is believed that diversification can lead to inefficient investment. This problem arises from directors' use of resources and excessive investment in projects with negative current value because of personal gain (Jensen, 1986). They concluded that managers in order to develop opportunistic behaviors in companies, increase the diversity of products reducing the quality of internal controls to conceal the transmission of negative information.

The second hypothesis of the research has confirmed; environmental uncertainty has a significant effect on the common interaction of diversification and the weakness of internal controls. The results show that environmental uncertainty leads to negative changes in performance so that in uncertainty situation, the diversification has no ability to moderate internal controls as a result of management behavior. The results of this hypothesis are consistent with the research by Armstrong et al (2011). The flow of information in the market environment affects the behavior of market actors. Environmental changes create the conditions that people in the market have a different contribution to this information flow. What is more important is the existence of an information environment that reduces ambiguity and uncertainty and thus increases the ability of investor prediction and analysis.

The third hypothesis of the research is that the financing limit has a significant effect on the joint interaction of diversification and the weakness

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of internal controls. While agency problems are usually due to excessive investment by managers with respect to personal interests, diversification leads to a change in liquidity situation in companies with liquidity constraints. In this context, the financing limitation simply leads to lower investment (Petty, 2003), the theory of modern investment suggests that companies are willing to invest in fixed return projects and, in the case of financing constraints, the managers' opportunity to weaken internal controls will be limited.

Keywords: Internal Control, Diversification, Financing Constraints, Environmental Uncertainty.

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