

Responsibility for Internal Control in Corporate Governance

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Abstract

Within organizations there are risks that are constantly evolving in achieving the scheduled objectives, which means that there may also be a chance of failure of their policies; therefore the internal control activities implemented must be correlated with the risk level established by the organization for each field or activity. Especially in corporate governance managers have become increasingly interested and have become more and more involved in the closer monitoring of the internal control system by assessing the risks they face. A particularly important role in the organization of the internal control system in an organization lies with the internal audit which must assist in maintaining effective controls by assessing their effectiveness and efficiencies and promoting continuous improvement. However, it should also be borne in mind that standardization of the audit process cannot increase the quality of the audit; this can be better observed in the case of external audit.

Considering this under the present article, I will look into certain aspects of internal control responsibility in corporate governance.

Key words: corporate governance, internal control, internal audit, auditors, organization

J.E.L. classification: G30, M40, M41, M42

1. Introduction

The general perspective of control, covering all aspects/fields of an organization, has led to the need to group all control activities in order to form an integrated whole, model or control framework that constitutes the support for the construction of its own internal control systems.

2. Literature review

The implementation of an appropriate internal control system, based on a general control framework, is intended to promote a fair control environment in organizations, and in turn the control environment allows an organization to develop its own control strategy in response to possible risks to achieving the objectives. On the other hand, the absence of a control framework can contribute to the separation of risk assessment work from internal control activities, and the internal auditor's efforts will be less valuable and will not be directed to an integrated picture that reflects all the risks of the organization. Ghiță (2008, p.126)

3. Research methodology

In this paper I set out to analyze certain aspects related to the responsibility of internal control in corporate governance. The research methods used will be data collection, processing and interpretation. I will also use bibliographic selection, as a research technique, and respectively reading, collecting and synthesizing data, as a research process.

4. Findings

In corporate governance, there are risks within organizations that are constantly evolving in achieving the scheduled objectives, which means that there may also be a chance of failure of their policies; therefore the internal control activities implemented must be correlated with the risk level established by the organization for each field or activity. (Ghiță, 2008, p.120)

Quoting Pickett regarding the role of the internal control system in an organization, Ghiță (2008, p.122) states that the Turnbull Report recommends:

- paragraph 10 – a company's internal control system plays a key role in the management of significant risks in achieving that company's objectives; a well-developed internal control system helps to protect the investments of shareholders and company assets;

- paragraph 11 – internal control [...] facilitates the effectiveness and efficiency of operations, assists in the reliability of internal and external reporting and assists in compliance with relevant laws and regulations.

Chen *et al* (2020), in another context, where internal controls are intended for risk management, this time investigating the way internal controls shape cash holding policies, have concluded that entities with a higher quality of internal control (ICQ) are less likely to have abnormal cash holdings, either excess cash or cash in deficit, and this effect, as the authors argue, is not determined by the quality of corporate governance, but instead in corporate governance, according to the authors, internal control helps entities to develop reasonable cash policies leading to the creation of value.

Within some entities, regarding the way that financial difficulty influences the choice of revenue management methods and how the quality of internal control moderates the relationship between them Li *et al* (2020) notes that entities in financial difficulty tend to pay close attention to the management of commitment revenues to the detriment of real income management but, on the other hand, internal control exerts a moderating effect on the relationship between financial difficulty and the management of earnings, by limiting both the management of commitment income and actual income. Also on the quality of income, as Ji *et al* (2020), argues, in a limited geographical context, in public entities, for example, careful, detailed self-assessments are carried out when a voluntary internal control report is issued, especially for the first time, and consequently, as the authors claim, there is an improvement in the quality of revenue.

At the same time investigating the relation between voluntary reporting of internal control weaknesses and the quality of earnings, the authors Ji *et al* (2017) shows that the quality of revenue, as measured by absolute adjustments/cumulations/discretionary commitments, is significantly associated with voluntary reporting of internal control weaknesses. In addition, according to the authors, both accounting and non-accounting internal control weaknesses affect the quality of revenue when the verification of non-accounting internal control weaknesses is essential for the management of entity's risks.

On the other hand, the authors Jakoby *et al* (2018) considers that the reduction in investments could be a potential explanation of why entities with voluntary reporting of internal control weaknesses are relatively less than entities that do not have voluntary reporting of internal control weaknesses. In the authors' view, a possible explanation for the reduction of investments is the higher costs of financial discrepancies associated with voluntary reporting of internal control weaknesses. Taking into consideration this explanation, the authors point out that entities that voluntarily report internal control weaknesses with credit ratings do not reduce their investments as much and perform much better than entities that voluntarily report internal control weaknesses but are without credit ratings.

Regarding the reporting of internal control authors Wang *et al* (2019) considers that, during the mandatory period of internal control reporting, when a voluntary internal control report is issued, it assumes a significantly lower debt cost than if a non-voluntary internal control report is issued, which can be explained by the superior quality of internal control if a voluntary internal control report is issued. According to the authors, the difference in the cost of debt is more pronounced when entities operate in industries at high risk of litigation and intense competition and when the information environment of the entities is weaker or, I add, in corporate governance, when the parent/group leader has a high demand for information related to the activity.

On the other hand, in a study conducted, the authors Chang *et al* (2020) have proposed, on the one hand, defining critical risk factors that influence the governance of an entity's internal control in an IoT (Internet of Things), (IoT - environment is a concept that involves using the Internet to connect different devices, services and automated systems with each other, thus forming a network of objects) and, on the other hand, to classified risk factors and study their importance in such an environment. Thus, following the research carried out, the authors finally concluded that in order to highlight how the risk factors of internal control of an entity involve various stakeholders, the critical risk factors being classified for mapping with different perceptions, in the new generation of IoT governance practices, the associated factors can be considered as essential elements of measurement for entities in carrying out an internal control and a more effective audit.

With regard to the structure of the internal control system, Ghiță (2008, p.123) mentions that an internal control system comprises the policies, procedures, tasks, conduct and other aspects of the company, which considered together:

- facilitates the effectiveness and efficiency of its operations by enabling an appropriate response to business, operational, financial, compliance and other risks that may prevent the achievement of the organisation's objectives. These systems include protecting property from improper use or preventing or defrauding them and ensuring that any debts are correctly identified and managed;

- takes part in ensuring the quality of internal and external reporting. They require the maintenance of adequate records and processes that generate a reliable, relevant and timely flow of information from within and outside the organisation respectively.

- take part in ensuring compliance with relevant laws and regulations and also with internal policies relating to business conduct.

At the same time, as Ghiță (2008, p.124) also mentions, I am of the opinion that a particularly important role in structuring the internal control system in an organization is the responsibility of the internal audit which must assist in maintaining effective controls by assessing their effectiveness and efficiency and by promoting continuous improvement.

Also Chang *et al* (2019) argue that in an entity the Internal Audit Function (IAF), this time, helps the entity's management to improve internal controls on operations, reporting and compliance. But, as the authors state, while many studies examine the association between the Internal Audit Function (IAF) and Internal Control Financial Reporting (ICFR), however, in their view, little is known about internal control over operations and compliance. Thus, by examining the association between the quality of the Internal Audit Function (IAF) and the deficiencies of internal control in operations and compliance, the authors concluded that a larger internal audit team can improve the performance of the internal audit for both operations and compliance, while the competence of the internal auditor is positively associated with the effectiveness of internal control over compliance, but not on operations. Finally, the authors concluded that an entity's control over operations and compliance can mutually influence internal control over financial reporting (ICFR) and ultimately the success of that entity in business.

In the same Time, the authors of Mascha *et al* (2018), examining the type of deficiencies in the internal control audit (entity or application level), notes that deficiencies in the internal control audit of both types can increase the risk of significant distortion, so that, in the opinion of the authors, it should be a primary concern for supervisors if audit entities carry out appropriate procedures to identify internal control audit deficiencies at entity and application level, including those involving general controls of information technology. Using text analysis to examine audit deficiencies based on the type of internal control and the size of an entity, the authors also find that significantly more application levels are identified than entity-level control audit deficiencies. Application-level control deficiencies generally involve revenue, inventory and receivables accounts, while entity-level deficiencies often imply a lack of centralized controls or controls on financial reporting at the end of the period.

According to the authors Li *et al* (2018) although internal auditors are increasingly aware of the importance and value of audit analyses, however previous research indicates that the use of audit analyses is below expectations. Thus, using the Technology-Organization-Environment - (TOE) framework to identify and examine organizational factors that influence the use of audit analysis after approval, as well as whether the use of audit analyses improves the performance of the

internal audit process, the authors found that application-level use is influenced by management support, technological competence and standards, while professional aid, technological competence and application-level use determine feature-level usage. Finally, both at the application and feature level, audit analytical uses improve the performance of the internal audit process.

The authors Liu & Huang (2020) argue, in the study conducted on a sample of 266 observations - foreign entities listed in the US, that entities that employ new auditors are more likely to remedy their material internal control deficiencies effectively in the coming year. Furthermore, the authors found that entities during the voluntary approval period are less likely to address internal control issues and that the remediation of internal control material deficiencies significantly improved the quality of their revenues. At the same time, the authors argue that the institutional differences in the country of origin of a foreign entity affect the reporting behavior of internal auditors' internal control as well as the effect of remedying material internal control deficiencies on revenue quality.

But, in my opinion, as the Knechel authors said, *et al* (2020), it should be kept in mind that standardization of the audit process cannot increase the quality of the audit. This can be better observed in the case of external audit, this time, where the authors argue that audit research should pay greater attention, on the one hand, to the different/particular nature of audit missions and the importance of successful cooperation between the service provider (audit entity) and the client, in order to improve the quality of the audit; and, on the other hand, that efforts to maximize the auditor's independence may have unexpected costs affecting the quality of the audit.

At the same time, in the same context, as the authors Bills *et al* (2020), argue, an entity's decision on the choice of the same auditor as the competing, close entity, may reflect a trade-off between exercising caution to protect its own information and tracking the benefits of auditor's knowledge derived from providing services to comparable clients.

Thus, the role of the internal audit on the organization and functioning of the internal control system includes (Ghiță, 2008, p.124):

- assessment of those areas that are most exposed to;
- defining and undertaking programs to verify internal control systems that raise the greatest risks;
- verification of each of these systems by examining and evaluating their associated internal control systems with a view to determining the extent to which the key objectives of the control are met;
- advising management on the implementation of internal control activities and whether they operate adequately and effectively in such a way as to promote the achievement of the objectives of the system/control;
- recommending any improvements necessary to strengthen the control, in a coercive manner, while also clarifying the risks involved in failing to carry out the recommended actions;
- follow up on the implementation of internal auditors' recommendations so as to identify in advance whether management has acted in accordance with audit recommendations;

Given that the control activities that are carried out within the organizations are moving the organization towards achieving its objectives, by respecting the predetermined working procedures, the main concern of the internal audit should also be, in my opinion, the focus on the need to verify internal control systems, obviously in addition to the other internal audit activities.

5. Frameworks under corporate governance

Especially in corporate governance managers have become increasingly interested and have become more and more involved in the closer monitoring of the internal control system by assessing the risks they face. At the same time, even from the perspective of the origin of managers, as Shen *et al* (2020), mention, the empirical results of the authors' studies showing that the rural origin of the CEO (Chief Executive Officer) could significantly improve the quality of an entity's internal control.

Authors Lu & Cao (2018) argue that the individual characteristics of the members of the Management Board, including education, experience, certification, integrity and training, are linked to the quality of internal control and therefore, in the opinion of the authors, the quality of internal control is better, the deficiencies of internal control are reduced and their remediation is most likely

frequently applied to entities where the members of the Board of Directors and the Chairman of the Board of Directors have stronger qualifications; in addition, the property having a moderating impact on the relation between the characteristics of the board and internal control. Thus, as the authors argue, it is absolutely necessary that in any entity and in corporate governance respectively, I add, that management knows that the characteristics of board members can make a difference.

Reviewing various studies, authors Chalmers *et al* (2019) suggests that the quality of internal control may have a significant effect on the decision-making by users of financial information, and with regard to the results of research on the empirical association between property structure, the authors argue that certain characteristics of the board and the quality of internal control are generally mixed; empirical evidence on the association between the characteristics of the audit committee and the quality of internal control generally supports a positive and significant view.

Also, as the authors claim Braumann *et al* (2020), interactive control reinforces the effect of top management's tone on risk awareness, while the tone given by top management and control are not empirically linked to each other in terms of creating risk awareness. So, as the authors argue, I agree with that, especially in corporate governance, the effect of tone from top management and interactive control become significantly stronger in a situation of perceived uncertainty over the environment.

Also the authors Malmi *et al* (2020) argue that cultural values and preferences significantly influence the interdependence of management control practices and suggest that special care should be exercised with regard to the intercultural generalization of complementarity of management control practices.

On the other hand, with regard to the association between the social ties of the board of directors and accounting conservatism, the authors Yin *et al* (2020) notes that there is a negative relation between them, which, in the authors' view, implies that several social connections of the board reduce the monitoring function of the board and encourages the CEO's tendency to adopt less conservative principles for their own personal gain. The authors also claim that they have found that the internal control system has the status of mediator between the cooperation of the CEO - Council and Accounting Conservatism. In the opinion of the authors this implies that the internal control system decided/concluded by the council could be the means by which the CEO achieves less conservative principles.

For this reason, as Ghiță said (2008, p.126), the general perspective of control, which comprises all aspects/domains of an organization, has led to the need to group all control activities in order to form an integrated whole, model or control framework that constitutes the support for the construction of its own internal control systems.

As the author said, the implementation of an appropriate internal control system, based on a general control framework, is intended to promote a fair control environment in organizations, and in turn the control environment allows an organization to develop its own control strategy in response to possible risks to achieving the objectives. On the other hand, the absence of a control framework can contribute to the fragmentation of risk assessment work from internal control activities, and the internal auditor's efforts will be less valuable and will not be directed to an integrated picture that reflects all the risks of the organization. I also believe that it should also be kept in mind that, as Buslepp *et al* (2019), states, the misclassification of audit-related fees/costs correlates with poor quality of internal control in an entity. So is Ji *et al* (2018), examining the association between internal control risk and audit fees under the voluntary adoption regime of the Basic Standard of Internal Control, notes that audit fees are positively linked to internal control weaknesses; in particular, in the opinion of the authors, they are significantly associated with internal control weaknesses related to non-financial reporting, but not to those related to financial reporting. The authors also concluded that voluntary insurance in internal control reports can nevertheless mitigate higher audit fees associated with internal control weaknesses.

Examining the cause of several entities to reveal weaknesses in internal control after having previously reported effective internal control, the authors Chen *et al* (2019) concluded that about half of the variables of the cross-section weaknesses of internal control either do not change significantly from year T-1 to year T or change in a direction that is not expected to cause internal control damage. The authors consider that the reported deterioration of internal control can be attributed to increases in audit duties/fees, turnover, certain ratings, financial difficulties, entity size

and decrease financial activities respectively.

Also related to high levels of audit fees and in the case of external audit, as claimed by the authors Hoffman *et al* (2018), companies with higher IT capabilities incur higher levels of audit fees. In addition, as customer size increases, audit fees from companies with advanced IT capabilities increase at a higher rate than companies without such capabilities.

6. Conclusions

In conclusion, given that the control activities that are carried out within the organizations are moving the organization towards achieving its objectives, by respecting the predetermined working procedures, the main concern of the internal audit should be, and in my opinion, the focus on the need to verify internal control systems, obviously in addition to the other internal audit activities.

It can also be said that the implementation of the control system within an organization and the adequacy of policies to achieve their objectives is the responsibility of the general management, and ensuring management regarding its functionality and monitoring the effectiveness of the system is the responsibility of the internal audit.

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