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Enterprise Internal Control: Review of Domestic and Foreign Studies

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Abstract: *After decades of development, internal control has gradually formed a relatively complete framework. Domestic and foreign scholars also have endless research on internal control. With the continuous expansion and deepening of the research, the importance of internal control for modern enterprises is undoubtedly revealed. This paper summarizes the definition and framework of internal control and the aspects of internal control defects and economic consequences, in order to have a deeper understanding of internal control.*

Keywords: *Internal control; Framework; Defect disclosure; Economic consequences*

1. Introduction

With the continuous development of economy, modern enterprises have better development prospects and broader space for development, and enterprises have ushered in a new period of strategic opportunities. However, with the increasingly fierce market competition, the lag of internal control and talent training, the development of enterprises is facing many problems. In their research, scholars at home and abroad have increasingly realized that enterprises with good operation condition and enduring prosperity must be inseparable from scientific and efficient internal control according to the development of enterprises themselves.

2. Literature Combing of Internal Control

2.1. Definition of the Internal Control

In the 1980s, there were many financial fraud phenomena when listed in the United States, which led to the bankruptcy of many enterprises. The large-scale bankruptcy triggered the attention of all walks of life in the American society. The National Committee on Fraud Reporting has adopted a series of solutions to such a large scale of fraud, the key being the establishment of the False Financial Reporting Committee (the COSO Committee) in 1985. The main purpose of its establishment is to use the review of corporate financial statements to curb fraud, and to provide basic data for the work of the fraud reporting committee. COSO After the establishment of the Committee, the primary task is to deeply explore the causes of enterprise bankruptcy and the phenomenon of untrue financial reports, so they choose to start from the fraud phenomenon of relevant research. Through the study of fraud in listed enterprises in the United States, it is found that the occurrence of fraud in these companies all points to the poor internal control effect of —— enterprises at the same source. Based on the results of this study, the COSO committee immediately embarked on a series of issues related to corporate internal control. After a lot of research and practice accumulation, the COSO Committee released an authoritative report on internal control in the 1990s, "Internal Control ——Integration Framework", which is also known as the COSO report. Since its publication, the report has been studied and implemented by a large number of American companies as the general principle of internal control. The COSO Committee has its own definition of internal control: “The procedures implemented by the company's board, management and other persons to provide reasonable assurance: the efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations.”

Wu Shuipeng (2000) conducted an in-depth study on internal control, and he believed that researchers should explain the characteristics of various aspects of internal control. So he summed up the following points: First, implementation, before the internal control to establish a good control goal, and its implementation is to achieve this goal. Second, it should be clear about the principle that internal control

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itself is not an end but a method. Any enterprise is not founded for the implementation of internal control, but internal control is a process in which the founding purpose (i. e., profit through production and operation) constantly changes with the business environment. Third, internal control does not exist alone. It always runs through the production and operation activities of the enterprise, to a certain extent, can provide a guarantee for the enterprise to achieve the goal. Fourth, when establishing internal control goals, the impact of the internal and external environment should be taken into account. Effective control of the enterprise's environment can make the goal of internal control more clear. Fifth, the role of employees in the internal control of the enterprise has its two sides. First, they implement control in their own work, and second, they are the object of control in the work of others. Sixth, for the enterprise, the most important thing is the employees in the enterprise. Therefore, the procedure of formulating internal control is developed around the “human” factor, so that a common concept will be formed to influence the internal control of the enterprise[1].

2.2. Framing of the Internal Control

Until the 1990s, before the overall framework of internal control was put forward, the development of internal control went through four stages. The first stage is the internal containment, the second stage is the internal control system, the third stage is the internal control structure, and the fourth stage is to the overall framework of the internal control. The idea of this overall framework has a very deep influence on the development of the internal control theory both at home and abroad. It includes several aspects, first is control environment. For enterprises, employees are in the most core position, and the development of the enterprise cannot be separated from the activities of employees, and the activities of employees also cannot be separated from the environment of the enterprise itself. These two elements complement each other and promote each other. Control environment is the engine of the enterprise, which affects the understanding and understanding of the enterprise internal control, and is also the core of the internal control, providing a solid foundation for the other four elements. The second is the risk appraisal. Enterprises will face many risks in the process of production and operation, and each enterprise has its own established goal, which is combined with business activities. In order to achieve the established goals, enterprises often need to identify and analyze the risks they may face in their operation. In addition, enterprises are in a constantly changing internal and external environment, and they need to establish a set of mechanisms to deal with risks, which is risk assessment. The third is to control activity. Generally speaking, in order to the smooth implementation of the decision, enterprises need to develop a series of procedures as a guarantee, which is the control activities. Only by following established procedures can the “ actions necessary to be used to identify and address risks have been effectively implemented.” Fourth, information and communication system. This system provides reports of operational, financial, and other information to support the execution of control activities. Employees can obtain relevant information about the enterprise through the information and communication system, which helps them to find their own position. Fifth, monitoring. The internal control system is not static. For the constantly changing market environment, the internal control system needs to be constantly updated, so it needs to be supervised to ensure that it plays its due effect. Enterprises usually use the independent evaluation to monitor the internal control.

2.3. The Development of Internal Control

In the 1940s, internal control began to emerge in western countries, with two major advances occurring after the release of the COSO report and the Sarbanes-Oxley (SOX) Act. COSO report promotes the construction of the overall framework for internal control, while the SOX Act extends the research to broader areas, such as the disclosure of internal control defects and economic consequences.

2.3.1. Disclosure of Internal Control Defects

Ashbaugh-Skaife, Collins (2007) and others studied the main factors leading to the failure of enterprise internal control and the motivation of managers to report internal control problems before the SOX Act. Research shows that companies that disclose defects in internal control are more chaotic in their own operations, with higher accounting risks, fewer auditors and fewer available internal control resources[2].

Doyle, Ge (2007) studied the factors associated with internal control through the disclosure of the company's internal control defects. The conclusion is that a company is more likely to have internal control problems if it contains the following features. The first is small and less profitable, so such companies have no extra energy to put into internal control. The second is companies with complex

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structure or rapid development. Finally, internal control at companies is facing problems[3].

Leone (2007) evaluated the relevant studies of the above scholars. Leone believes that the chaotic operation and the amount of internal control resources did have an impact on internal control, but has different views on the content of audit in the above studies. In his opinion, the number of auditors is not related to the disclosure of the company's internal control defects. In addition, he believes that the research of the above scholars only focuses on a short period of time, and whether such research has reference significance for the accuracy of internal control disclosure in a large time range needs to be further verified. Of course, Leone is positive about the above research, saying that the above research provides a framework for the concept of internal control defect disclosure, which means that the subsequent research has laid a solid foundation for future research[4].

Hogan, Wilkins (2008) found that if the company disclosed internal control defects, the audit costs of auditors will increase, the more serious the defect of the company will have greater audit risk, the more to bear higher audit costs. But if the defects can be made up in time, the cost can be reduced[5].

Beng Wee Goh (2007) believes that whether the internal control defect is found is an important factor in whether the company changes its management. Companies whose internal control defects are found are more likely to reorganize their top executives to improve the independence of their internal audit than companies that do not[6].

2.3.2. Economic Consequences of Implementing Internal Controls

Internal control of economic consequences, is also the focus of scholars. Scholars hold different views on it.

(1) Internal Control brings Positive Consequences to the Enterprise

High-quality internal control can improve the enterprise information system and financial information quality. Lambert (2007) and others believe that the company's capital cost is affected by the accounting information, and to reduce the capital cost of the company, high-quality accounting information is needed[7]. Ashbaugh-Skaife, Collins (2009) and others believe that strengthening internal control can improve the quality of accounting information. The defect of internal control means that the authenticity of financial information is in doubt, and the quality of accounting information is also low. In addition, if the high-quality internal control report is provided to the auditor for evaluation, the audit opinion issued by the auditor is more likely to be consistent with the real operating situation of the enterprise. For enterprises, such an audit report is undoubtedly favorable[8]. Hu Mingxia (2018) believes that the production, operation and sales of enterprises run through the implementation of internal control, and the sales and revenue in earnings management are within the scope of internal control, so high-quality internal control can effectively reduce the cost of earnings management[9].

High-quality internal control can reduce the cost and operational risks of enterprises. According to Yang Qingxiang (2010), experts advise investors to raise companies with internal control defects to demand a risk premium. In the process of credit rating, the quality of internal control of an enterprise is also a very important factor[10]. Enterprises with internal defects often do not have an advantage in credit rating, thus affecting the financing operation of the enterprise. From the above statement, it is easy to draw a conclusion that the internal control defects will make the financing costs higher. Ashbaugh-Skaife, Collins (2009) study believes that companies with internal defects need to bear higher equity costs. The Cassell, Myers (2011) study shows that many companies following SOX Act Section 404 were able to reduce lower financing costs (including equity costs and debt costs). Bargeron, Lehn, and Zutter (2010) and others also believe that the cost of equity and debt for American companies has decreased after the implementation of the SOX Act. In this way, enterprises can also reduce the risk in the business process[11]. Thus, these scholars believe that enhancing internal control is an effective means to reduce corporate financing costs and operational risks. He Xuexia (2020) believes that investment can be divided into excessive investment and insufficient investment, while high-quality internal control can improve the accuracy of the judgment of the enterprise, in order to avoid excessive investment or underinvestment, so that the investment efficiency of the enterprise is improved; secondly, she believes that the internal control will also affect the financing activities of the enterprise, and its impact is mainly reflected in the financing cost of the enterprise[12]. Chen Hanwen (2014) believes that the business environment of enterprises is related to high-quality internal control.By improving the quality of internal control, an enterprise can send a good signal to creditors, according to which creditors can judge that the risk of its investment in the enterprise is low, and the enterprise can reduce its financing cost[13].

High quality internal control can be a positive factor for corporate governance, in the process. Internal

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control is a series of relevant principles and organizational procedures established by enterprise management in order to achieve its management goals, so internal control provides power for corporate governance and corporate management. Especially in today's more and deeper marketization, when the modern enterprise system has become the consensus, the goal of internal control is no longer the traditional supervision and management, but to ensure the implementation of the policies formulated by the management and the realization of the whole process management of the company's operation. Under the operation of the modern company system, the internal control is reflected in all aspects of the internal management, which has become an extremely important part of the company management[14]. Abbott (2007) and others believe that the level of internal control quality is closely related to the sound degree of the corporate governance mechanism. That is, the higher the quality of internal control, the more likely it is to have a sound corporate governance mechanism[15]. According to Hochberget (2009) and others, the implementation of SOX Act can reduce the possibility of mismanagement, and reduce unreasonable behavior and improve the management level of the whole company[16]. Michelon, Beretta (2009) took a number of foreign companies as samples to study the various mechanisms of internal control together with the company's internal supervision agencies. They believe that the implementation of some internal control mechanisms can replace some supervisory agencies of the company to some extent. If the implementation of the internal control system can be replaced by the supervisory agencies, the agency cost can be reduced, and the funds can be used in other fields, so as to better achieve the business goals. Feng, Li (2009) believe that efforts to improve the quality of internal control is beneficial to the enterprise. Through research, they found that if enterprises do not pay attention to the improvement of internal control quality, then the prediction accuracy of their future operation and management strategies will be reduced to a certain extent. They believe that by discovering and changing the problems in the internal control, it can promote the company's top-level management to abandon its past unscientific management mode, and the higher quality internal control will also have a good impact on the management's subsequent decisions[17].

High-quality internal control can give external investors a more effective judgment. Jams (2003) found that the market response was affected by the quality of internal control. In the face of internal control defects, corporate investors will be more cautious and hesitant, while good internal control will attract investors, which indicates that investors attach great importance to internal control information and can provide reference for them to make decisions. In the research of Shi, Wang (2011), improving the quality of internal control can provide reliable and useful information for external investors to make investment decision adjustment, that is, investors can use the level of internal control quality as the barometer of investment changes; the continuous adjustment and control of internal control quality also effectively reduces the information difference between management and external investors. On the other hand, they believe that improving the quality of internal control promotes improving the quality of the company's financial reporting, which in turn restores the confidence of outside investors. Li Zhibin (2009) pointed out that in the current market environment, the protection of the rights and interests of investors is very important. In the eyes of investors, strengthening the internal control and disclosing the internal control information is an effective protection of their own rights and interests, because it means that they have a more intuitive and in-depth understanding of the enterprise, and the quality of communication between the two sides is further enhanced[18].

(2) Internal Control brings Negative Consequences to the Enterprise

There are also many scholars who believe that the impact of internal control on the company is not all focused on the positive aspects. The negative effects of internal control are apparent under certain conditions.

Zhang (2007) study of the economic consequences after the implementation of the SOX Act found that the return rate of foreign companies listed in the United States was significantly lower than that of those not listed in the United States, which shows that the implementation of the law increased their costs for companies listed in the United States. In addition, Zhang (2007) found that after improving the quality of internal control and management level, the company did not get the due benefits, but caused more losses[19].

Many foreign scholars' research on the negative impact of internal control focuses on internal control, which increases the cost of the company. Abbott, Parker, Peters, Rama (2007) believe that due to the introduction of SOX Act, the internal audit business must be audited by the internal audit department but not to external institutions, which undoubtedly increases the cost for small companies. Engel, Hayes, and Wang (2007) study is based on the privatization of public companies to illustrate the negative impact of the SOX Act. These scholars believe that smaller companies will increase their operating costs if they change their business strategies under the bill[20].

3. Conclusions

From the above literature, it is not difficult to see that for decades, domestic and foreign scholars on the internal control of enterprises has three characteristics.

First, despite the continuous development of the internal control theory, its connotation has been quite rich. It is not only limited to the traditional theory of mutual restraint based on accounting and auditing, but also focuses on the overall framework of the enterprise. As mentioned in the COSO report, the "responsibility" of the internal report, this responsibility is for all employees in the enterprise, and not only the management in the enterprise has the responsibility to conduct internal control. Establishing this organizational idea, employees can take the initiative to maintain internal control rather than under the pressure of management, so as to improve the overall efficiency of the enterprise.

Second, the research of domestic and foreign scholars also reflects that the internal control plays an auxiliary role. Wu Shuipeng and other scholars also stressed that internal control needs to be combined with the business activities of the enterprise, rather than being independent of the basic business activities of the enterprise. Enterprises to improve the defects of their own internal control and improve the quality of internal control is for the business activities of service, the implementation of high-quality internal control can better achieve the business objectives. Therefore, the internal control system formulated by enterprises is a tool of enterprise management, which is not equivalent to enterprise management.

Third, most of the research focuses on the positive effect of effective internal control on enterprises. For example, effective internal control will reduce costs, reduce risks, increase financial information costs, have a positive impact on corporate governance, and give investors stronger confidence. Although some scholars believe that internal control does not have a positive effect on enterprises, compared with the positive influence research, the selection range of research samples is small and the representativeness is lacking.

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