

Analysis and Research on ICW of Listed Companies —— Taking DYNAVOLT TECH Company as an Example

Yuanming Dou

*Institute of Accounting, Capital University of Economics and Business, Beijing, China
douyuanming2019@163.com*

Abstract: *In recent years, numerous academic articles on ICW and the disclosure of publicly traded companies have been published. It is evident that research on ICW is extremely important. Using the STDYNAVOLT Company as an example, this paper examines in depth the causes, identification standards, specific types, and improvement measures of internal control significant vulnerability, and provides corresponding recommendations and summaries.*

Keywords: *listed companies, internal control audit, significant vulnerability, MRIC*

1. Introduction

Enron and Andersen committed financial fraud in the United States in 2000, which led to the passage of the Sarbanes-Oxley Act, also known as the "Accounting Reform and Investor Protection Act of Listed Companies", in 2002. Its primary purpose is to require companies to comply with securities laws in order to improve the accuracy and dependability of corporate disclosure, thereby protecting investors. This Act has far-reaching effects on the growth of internal control in the American auditing industry and beyond. Under the influence of this Act, China began focusing on the compliance of corporate internal control reports and, in 2008, issued the Basic Standards for Corporate internal control and the Supporting Guidelines for Corporate internal control. In 2011, the CICPA issued opinions on the implementation of audit guidelines for corporate internal control. However, due to the idiosyncrasies of the market order, the profit-seeking nature of enterprises, and gaps in the supervision of legal norms, many listed companies still have significant internal control weaknesses, and financial fraud, such as the Kangmei Pharmaceutical and Zhangzidao incidents, occurs frequently.

Therefore, it is of the utmost importance to strengthen the construction of internal control and promptly disclose its significant weaknesses. What is the standard and definition of internal control weakness (ICW)? How to handle ICW? What causes the onset of ICW? What is the relationship between the ICW self-evaluation report and the audit opinion report on internal control? What specific types of internal controls exist? Are all questions study-worthy? On the basis of the case study of DYNAVOLT TECH Company, this paper analyzes ICW, summarizes the reasons, and offers some recommendations that are anticipated to be adopted by predecessors.

2. Literature Review

I summarized the research literature on ICW published in recent years: He Limei (2018) provided a summary of ICW from the perspective of three internal control objectives[1]; Dong Huina (2019) found that many listed companies deliberately hide the internal control significant vulnerability, only disclosing general defects, while auditors failed to timely issue non-standard internal control audit opinions[2]; Lan Sha and Miao Zeyan (2019) analyzed that under the premise of controlling variables, the more ICW disclosed by listed companies, the higher the efficiency of enterprise value creation[3]; Zhao Hairong (2020) took ST Tianhua company as a case to analyze the difference in the recognition level of the internal control significant vulnerability between the internal control audit report and the internal control self-evaluation report, and analyzed the reasons for the difference and the measures to eliminate the difference[4]; Chen Wuchao and Jia Lili (2021) analyzed that nearly half of the listed companies did not truthfully disclose the internal control significant vulnerability from the perspective of the internal control audit report of listed companies, and discussed the impact of this behavior on the

company's business performance[5].

There are few analyses and studies on the disclosure of internal control defects from the perspective of an internal control self-evaluation report, as previous scholars have primarily focused on the analysis of internal control defects from the perspective of an internal control audit report. Therefore, it is necessary to conduct additional research and analysis on the internal control deficiencies.

3. Concept and Identification

3.1. Definition of ICW

As we all know, internal control is an organization, plan, procedure, and method of various restrictions and adjustments implemented within a unit in a particular environment, which serves as a type of means and measures to improve the operating efficiency, obtain and utilize various resources effectively, and attain the predetermined management objectives. The five essential components of internal control are the internal environment, risk assessment, control activities, information and communication, and supervision and inspection. And ICW indicates that neither the design nor the operation of the company's internal control can reasonably guarantee the achievement of the internal control's objective. It is primarily subdivided into general flaws and serious vulnerabilities, the focus of this section. Due to the fact that its emergence indicates that the internal operation of the organizational unit deviates significantly from the control objectives and auditors can easily issue negative opinions or refrain from issuing opinions, the company should make every effort to reduce the internal control's significant vulnerability and develop reasonable countermeasures.

3.2. ICW Accreditation Standards

China's regulatory authorities have established qualitative and quantitative ICW recognition standards. Quantitatively, when a company's financial statements are materially misstated, the probability that an account cannot be recognized exceeds 5 percent, the misstatement amount exceeds 5 percent of the pre-tax profit of current business and 0.5 percent of the total revenues and expenses, or the auditor issues an unfavorable opinion, the internal control is deemed to be significantly deficient;; It is subdivided into non-financial reporting ICW and financial reporting ICW from a qualitative standpoint. However, different companies have slightly different ICW recognition standards, which must be evaluated based on each company's unique circumstances.

4. A Case Study on the Internal Control Significant Vulnerability of Listed Companies

4.1. Introduction of Guangdong DYNAVOLT Company and Identification Standard of Internal Control Significant Weakness

Shantou Humei Battery Co., Ltd. established Guangdong DYNAVOLT New Energy Technology Co., Ltd. (abbreviated as ST DYNAVOLT, stock code: 002684) in 2001 as a joint-stock company. It has more than 30 years of experience in battery manufacturing and was listed on the Shenzhen Stock Exchange in 2012. DYNAVOLT TECH takes as its starting point the transition of human society from the fossil energy era to the renewable clean energy era and the Chinese government's "the belt and road initiative" national strategy, builds a globally competitive ecological chain of clean energy with the lithium battery industry chain as its core, supplemented by clean energy power generation and energy storage, core components and operation of new energy vehicles. The annual operating income is 900 million yuan and the net assets are 100 million yuan.

From the level of recognition of significant internal control weaknesses in the financial report: first, the qualitative perspective. Directors, supervisors, and senior management personnel of the company cheat and cause significant losses or negative effects; Significant weaknesses in financial report internal control that have been identified and reported to management have not been remedied within a reasonable time frame. If significant accounting errors are discovered and the company corrects the financial report, it can be determined that the company's financial report contains significant weaknesses. Second, quantitative considerations. If the financial report misstatement caused by this flaw alone or in conjunction with other flaws exceeds 2% of total assets, it will be considered a material weakness.

From the recognition level of internal control significant weakness of non-financial report: from the qualitative perspective, important business lacks system control or system fails systematically; The frequent exposure of negative news in the media has severely damaged the company's reputation, which is difficult to recover from; If the internal control significant weakness or important defects are not rectified, it can be considered that the internal control significant weakness is material. Implementation of the quantitative standard of non-financial reporting ICW evaluation is based on the quantitative standard of financial reporting ICW evaluation.

4.2. Analysis of ST DynaVolt's 2018 Financial Report Internal Control Significant Weakness

First, the company has inadequate cash flow risk management, a lack of reasonable and effective planning, and an excessive reliance on financing from financial institutions such as banks. When a financial institution's credit is tightened, loans are withdrawn or cannot be renewed, the cash income is unable to meet the cash expenditures, resulting in large-scale financial institutions' loans becoming delinquent.

Second, when the company undertakes photovoltaic power station projects externally, it does not thoroughly evaluate the funding source and payment time of the project owner, which increases the risk that the project owner will not make timely payments due to policy changes.

Thirdly, the company's early investment is risky, the feasibility study and risk assessment of the project are insufficient, the risk prevention mechanism of policy and economic environment changes is not scientifically established, and some investment decisions are erroneous, all of which contribute to the investment project income of the company not meeting expectations.

4.3. Causes of ST DynaVolt Internal Control Significant Weakness

4.3.1. The internal financial supervision department of the enterprise fails to perform its duties.

The interest payable at the end of 2018 increased by 118,964,700 yuan, or 684.80 percent, when compared to the end of 2017. It is anticipated that the liabilities will increase by 111,440,000 yuan, or 140,259.1 percent, by the end of 2018. This is a result of the company's lack of funds, its inability to pay the increase in interest accrued by some financing institutions, and the increase in pending financing litigation, estimated financing liquidated damages, product quality margin, etc. However, the company's financial supervision department failed to detect the lack of cash flow in time, resulting in uneven lending, an escalating debt ratio, and a struggle to make ends meet. Consequently, internal control produced significant financial liability weaknesses.

4.3.2. Internal control related to receivables is not effective enough.

The annual report of the company reveals that a significant number of accounts receivable have not been collected. Bills receivable and accounts receivable decreased by 47,680,200 yuan and 1,654,960,200 yuan, or 72.61 percent and 49.77 percent, respectively, at the end of 2018; Long-term receivables decreased by 83,341,200 yuan, or 34.63 percent, at the end of 2018. This is because the customer did not timely pay the accounts receivable and the company did not make a sufficient allowance for bad debts and accounts receivable impairment. Accounts receivable are accounted for by debiting "accounts receivable" and crediting "main business income," "taxes payable," and "value-added tax payable (output tax)." Therefore, from an accounting perspective, an increase in accounts receivable will increase enterprise profits, but an increase in enterprise profits does not guarantee a timely cash inflow. The existence of a large number of receivables in enterprises inflated the sales revenue on the books, to a certain extent inflated the profits of enterprises, but forced enterprises to use limited working capital to advance various taxes and expenses, accelerated the cash outflow of enterprises, easily caused the high asset-liability ratio of enterprises, and increased the burden of capital turnover on enterprises. This is an ominous sign.

4.3.3. Ineffective and improper financial management

Before investing in a project, a business will typically conduct a risk assessment, calculate the expected rate of return, conduct a feasibility study, and develop risk response measures. Clearly, STDYNAVOLT did not strictly implement these steps, and there was no reasonable planning, which resulted in the failure to generate the anticipated revenue. DynaVolt Tech's net income was 2,859,295,500 yuan and its net assets were -67,786,200 yuan as of the end of the reporting period on December 31, 2018. The company's operating income has experienced negative growth, and the

project's revenue is meager. This is not only the result of inadequate asset evaluation and project planning, but also a large number of delinquent loans and lease payments from financial institutions. The judiciary has frozen a great number of the company's bank accounts and assets, and liquidity is extremely low. The combination of multiple factors causes a precipitous decline in the company's net income.

4.4. Comparison and Analysis of Self-Evaluation Report and Internal Control Audit Report of ST DynaVolt Internal Control

According to both parties' reports, their respective contents and conclusions are essentially identical. The significant vulnerability of the internal control self-evaluation report of DYNNAVOLT Company is reflected in the auditor's non-standard opinions and highlighted sections of the internal control report, and the internal control is generally effective. However, there is a minor distinction between the two. The internal control audit report audits only the financial statements of the audited company, but not the non-financial reports of Internal Control. However, the self-evaluation report issued by DYNNAVOLT will evaluate the non-financial aspects, such as the fraud of the company's directors, supervisors, and senior management, despite the absence of deficiencies in STDYNNAVOLT's non-financial reports; In addition, I believe that, for the sake of the company's performance and reputation, the internal management may cover up some significant vulnerability disclosures when releasing the self-evaluation internal control report at the end of the year, so as to prevent adverse effects on the company. However, this is merely my hypothesis, which I hope will be confirmed in the future.

5. Conclusions and Recommendations

5.1. Rectification Measures for the above Internal Control Defects of STDYNNAVOLT

First, the company should strengthen cash flow management, improve cash flow risk warning, strengthen cash flow budget management and supervision and management, implement effective cash flow forecasting and in-process control measures, enhance the standardization and practicability of the company's cash flow management, and implement effective measures to control costs, save costs, and control cash outflow.

Second, we should further strengthen the collection of receivables of the company and its subsidiaries, and take legal action or exercise pledge right for overdue receivables to urge customers to realize the return of pledged assets, so as to protect the company's and shareholders' interests; Actively communicate with banks and other financial institutions to reduce the company's debt repayment pressure and default risk through loan extension, loan renewal, and in-kind financing.

Thirdly, according to the existing policies, we should conduct photovoltaic power station business prudently, with payment reliability as the primary criterion for new projects, giving priority to those with good quality, guaranteed payment, and a high payment ratio. For projects that have not been paid back in the previous construction period, the equity pledge is adopted to protect the rights and interests of payment, and the owner is negotiated with to obtain payment.

Fourthly, the company's board of directors should adjust and optimize the company's development strategy, shifting from the original "troika" of lithium batteries, clean electric power, and electric vehicles to "a business system with energy storage as the core, supplemented by power engineering and new energy application, with a focus on ensuring the competitiveness of energy storage business by strengthening and improving battery business," and investing more resources into energy storage.

5.2. From a Macro Perspective, Put forward Suggestions to Solve the Internal Control Significant Weakness.

From the perspective of regulatory authorities, we should actively formulate rules and regulations pertaining to internal control and closely monitor the illegal activities of listed companies, particularly those of their management and shareholders. In addition, we should immediately address violations such as financial fraud and high-level fraud, strengthen the supervision of the internal control link of listed companies and the internal control evaluation link of auditors, and require listed companies to disclose ICW in detail, classifying them according to the types of defects and five elements of internal control, including design and operation defects, significant vulnerability, etc.

From the perspective of listed companies, it is necessary to strengthen employee training, provide internal control training courses, and have all employees participate in internal control in order to improve employees' internal control execution ability, ensure the effectiveness of internal control design and operation, and make employees aware that effective and sound internal control can increase enterprise performance and net profit. Simultaneously, senior managers and other management should be accountable and self-monitoring, and they should not engage in illegal activities such as fraud and bribery. All significant internal control weaknesses should be disclosed in a comprehensive and detailed fashion, and there should be no concealment or fraud.

From the auditor's perspective, accounting firm members, as external appraisers, should have strong independence and improve their professional competence in order to accurately evaluate the effectiveness of internal control over financial statements, identify major misstatement risks and internal control deficiencies, and render appropriate audit opinions. In addition, professional ethics and relevant accounting and auditing standards must be observed during the internal control evaluation process to ensure compliance with the audit process.

Annotate

The data in this case study are all from ST DYNAVOLT 2018 financial statements.

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