

# Literature Review on the Disclosure of Internal Control Information

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**Keywords:** the disclosure of internal control information; internal control deficiency; voluntary disclosure; mandatory disclosure

**Abstract:** This paper first reviews the system background related to the disclosure of internal control information in China, then analyzes the current status of the disclosure of Shanghai and Shenzhen A-share internal control information, and concludes literature related to the motivation and economic results of the disclosure of internal control information.

## 1. Introduction

For the development of Chinese companies in recent years, bankruptcy incidents due to unreal financial, unlawful business operations, and poor management exist. The reason is the lack of internal control system or effective implementation of internal control. There are different degrees of information asymmetry between the company and the investors. The disclosure of internal control information reveals the basic situation of internal control of the enterprise and increases the effectiveness of the financial report by disclosing its internal control self-evaluation report and internal control audit report, playing an important role in solving information asymmetry. By virtue of experiences from foreign countries, China issues a series of laws and regulations and is constantly improving the internal control system. At present, relatively comprehensive and standardized disclosure system of internal control and information has been formed. Based on the disclosure of internal control information and whether it can truly reflect the internal control inside company, this paper, taking A-share listed companies in Shanghai and Shenzhen in 2010-2017 as object, analyzes the disclosure of internal control information and its motivation and economic results.

## 2. Systems Related to the Disclosure of Internal Control Information in China

The internal control system in China can be divided into two stages, and the first stage is voluntary disclosure before 2012. Although the *Guidelines for Internal Control of Listed Companies of Shanghai Stock Exchange* and *Guidelines for Internal Control of Listed Companies of Shenzhen Stock Exchange* in 2006 require listed companies to disclose internal control self-evaluation reports and the evaluation opinions on relevant contents of accounting firms when they disclose annual reports, the *Notice on Doing a Good Job in the 2006 Annual Report of Listed Companies* issued by Shanghai Stock Exchange and Shenzhen Stock Exchange in the same year only encourage qualified listed companies to implement the above methods. In May 2008, the *Basic Standards for Internal Control of Enterprises* was promulgated, requiring enterprises to issue self-evaluation reports on internal control; accounting firms engaged in internal control audits should audit the effectiveness of internal control of enterprises and issue audit reports. In 2010, five ministries like the Ministry of Finance and the China Securities Regulatory Commission jointly issued the *Guidelines for Enterprise Internal Control*, including *Guidelines for Application of Internal Control of Enterprises*, *Guidelines for Internal Control Evaluation of Enterprises* and *Guidelines for Auditing Internal Control of Enterprises*, which put forward specific requirements for internal control and information disclosure. The second stage is mandatory disclosure after 2012. *Notice on the Implementation of the Internal Control Standards for the Main Board Listed Companies in Batches and Types in 2012* requires that from January 1, 2012, the main board listed companies implement the internal control standards in batches and types, and disclose internal control evaluation reports and internal control

audit reports. By 2014, except for special circumstances, other main board listed companies should disclose relevant information on internal control when they disclose the 2014 annual report. In 2014, the *Information Disclosure Rules No. 21 of the Companies with Public Issue* also stipulated relevant rules for disclosure of internal control deficiency.

### 3. The Disclosure of Internal Control Information in A-share Listed Companies in China

This paper selects A-share listed companies in Shanghai and Shenzhen in 2010-2017 as sample, and analyzes the disclosure of internal control information. Relevant data come from CSMAR database.

#### 3.1 The disclosure of internal control evaluation report

This paper analyzes the disclosure of internal control evaluation report of A-share listed companies in 2010-2017. From Table 1, it can be seen that since 2010, the number of self-evaluation reports of listed companies has increased year by year, and the ratio of disclosures in 2013 has increased by 9.75% than 2012.

Table 1 The disclosure of internal control evaluation report

Year	internal control evaluation report disclosed		internal control evaluation report undisclosed		Sum
	Number	Proportion	Number	Proportion	Number
2010	1571	74.56%	536	25.44%	2107
2011	1847	78.90%	494	21.10%	2341
2012	2227	90.16%	243	9.84%	2470
2013	2338	99.91%	2	0.09%	2340
2014	2679	98.10%	52	1.90%	2731
2015	2706	93.89%	176	6.11%	2882
2016	2958	92.18%	251	7.82%	3209
2017	3257	98.04%	65	1.96%	3322

It further analyzes the effectiveness of internal control and internal control deficiency in the samples of internal control evaluation reports. From Table2, it can be seen that the proportion of companies with effective internal control in 2010-2012 is 99.82% and above. Whereas, it decreases after 2012, it still reaches 98.74% in 2017. With the improving laws and regulations on the disclosure of internal control information, companies with the disclosure of internal control deficiency are increasing, also with an increasing proportion of 17.24% from 2011 to 2012 and 12.62% from 2014 to 2015.

Table 2 The effectiveness of internal control and deficiency

Year	The effectiveness of internal control			Internal control deficiency		
	Effective (Number)	Proportion	Sum	Deficiency (Number)	Proportion	Sum
2010	1568	99.94%	1569	75	4.78%	1570
2011	1844	99.89%	1846	186	10.07%	1847
2012	2219	99.82%	2223	607	27.31%	2223
2013	2329	99.62%	2338	531	22.71%	2338
2014	2659	99.25%	2679	588	21.95%	2679
2015	2693	99.56%	2705	935	34.57%	2705
2016	2941	99.43%	2958	991	33.50%	2958
2017	3216	98.74%	3257	1148	35.25%	3257

#### 3.2 The disclosure of internal control audit report

This paper reveals the disclosure of internal control audit reports in A-share listed companies in

2010-2017. From Table 3, it can be found that whether in number or proportion, companies disclosing internal control audit reports are increasing year by year, with an average of 76.82% after 2014. According to the types of audit opinions, the average number of unqualified opinions in 2010 and 2011 was as high as 99.62%, and decreased after 2014, but the average proportion is 95.61%.

Table 3 The disclosure of internal control audit report and audits with opinions

Year	The disclosure of internal control audit report					Audit opinions		
	Disclosed		Undisclosed		Sum	Unqualified opinions		Sum
	Number	Proportion	Number	Proportion	Number	Number	Proportion	
2010	625	29.66%	1482	70.34%	2107	624	99.84%	625
2011	995	42.50%	1346	57.50%	2341	989	99.40%	995
2012	1496	60.57%	974	39.43%	2470	1471	98.33%	1496
2013	1788	76.51%	549	23.49%	2337	1736	97.09%	1788
2014	2123	77.74%	608	22.26%	2731	2044	96.28%	2123
2015	2282	79.18%	600	20.82%	2882	2173	95.22%	2282
2016	2343	73.01%	866	26.99%	3209	2232	95.26%	2343
2017	2569	77.36%	752	22.64%	3321	2458	95.68%	2569

From the analysis, it can be found that in voluntary disclosure, the companies disclosing internal control self-evaluation reports in 2010-2011 accounted for 76.73%. In the sample of internal control, the proportion of companies with effective internal control was as high as 99.915%, and the proportion of companies with internal control deficiency was 7.425%. However, due to the impact of disclosure costs, the disclosure of internal control audit reports is relatively low, averaging 36.08%. However, in the sample of internal control audit reports, an average of 99.62% of the companies were given unqualified opinions. This shows that in voluntary disclosure, listed companies report only the good news and not the bad, and enterprises with better internal control tend to disclose internal control information.

In mandatory disclosure of 2012-2017, the average percentage of companies that disclose internal control self-evaluation reports is 95.38%, which is much higher than the voluntary disclosure stage. In the sample of internal control, the proportion of companies with effective internal control is as high as 99.4%, and the proportion of companies with internal control deficiency is averagely 29.22%, higher than voluntary disclosure. It shows that with the continuous improvement of the internal control system, the disclosure of internal control related information is more inclined to truly reflect the internal control of the enterprise. The companies that disclose the internal control audit report increased significantly compared with the voluntary disclosure, with an average ratio of 74.06%. The internal audit opinion on internal control of 96.31% of companies was given unqualified audit opinion.

#### 4. The Motivations for the Disclosure of Internal Control Information

In voluntary disclosure, the disclosure of internal control information is actually to transmit signal to the market. Companies with better quality of internal control tend to disclose their appraisal reports of internal control, whereas, companies with poor financial status and violation are unwilling to disclose appraisal reports of internal control (Lin Bin et al, 2009). Fang Hongxing et al (2012) believe that signal transmission and agency problem alleviation are the main motivations for companies to voluntarily disclose appraisal reports on internal control. However, whether it can be disclosed depends on the motivations of voluntary disclosure and whether auditors are willing to issue appraisal report of internal control. Therefore, the appraisal scope and degree of guarantee is analyzed from the perspective of auditors.

Song Chang et al (2013) think that the disclosure of internal control information for companies follows the principle of profitability of costs. From the perspective of financing demand, they find out that companies with financing demand can obtain direct profits from disclosing internal control information, so they are motivated to disclose. Cui Zhijuan (2011) finds out that there is motivation selection behaviors in the disclosure of internal control information of listed companies in

disclosure costs and agency problem. Zhao Xi and Xu Ningning (2014) also prove and specifically analyze the motivation selection behaviors of management level. Xu Jiangbo and He Xiaodan (2016) take enterprises' disclosure motivation into account, analyze the causes for predicament of internal control deficiency and find out influencing factors based on whether internal control deficiency can be found.

In mandatory disclosure, scholars pay more attention to the disclosure of internal control deficiency. The misunderstandings of investors for the disclosure of internal control deficiency information have a negative impact on companies that disclose internal control deficiency, thus limiting the inherent motivation of enterprises from disclosing internal control deficiency information. She Xiaoyan and Bi Jianqin (2018) believe that impacted by negative bias, listed companies have motivations to hide or not fully disclose internal control deficiency. Shi Lei et al (2018), according to the disclosure of internal control information, in terms of four aspects, including cheating of directors, supervisors and senior management personnel, the company correcting the published financial statements, serious misstatements in the current financial statements, and the failure of finding the misstatement during the operation, and the noneffective supervision of company audit committee and internal audit institutions, think that there are major deficiencies in companies, find out that listed companies have behaviors to deliberately downgrade the level of internal control deficiency, which influences the reliability of the disclosure of internal control information.

These literatures conduct a static analysis on the motivations for listed companies to disclose internal control information with the sample data of voluntary and mandatory disclosure. Chi Guohua et al (2018) taking the data of 2007-2016 as the sample, dynamically analyzes the influence of characteristics of board of directors on the disclosure of internal control deficiency information from the perspective of system transformation, and finds out that the improving internal control system can alleviate the influence and effectively the opportunistic behavior of board of directors.

## **5. The Economic Results of the Disclosure of Internal Control Information**

In terms of the economic results of the disclosure of internal control information, this paper reviews from the objective of internal control.

For the goal of assets security, scholars conduct researches from the market reaction. Ye Kangtao et al (2015) find out that the disclosure of internal control information is negatively correlated to price collapses. Jiang Hongyun et al (2018) further analyze the information disclosure of five elements of internal control, and find out that in companies with poor performance and governance and low information transparency, the disclosure of risk assessment information has significantly increased the risk of enterprise share price collapse, the disclosure of internal supervision information and improving internal control quality have significantly reduced the risk of enterprise share price collapse, and the disclosure of other internal control information is not significantly correlated to the risks of price collapses.

With regard to the truthfulness and completeness of financial reports and related information, scholars mainly conduct researches from earnings management. Fang Hongxing et al (2011, 2014) believe that in voluntary disclosure, if the company discloses its internal control appraisal report, it indicates that its internal control quality is high, which can restrain its earnings management; if the disclosed appraisal report is reasonably guaranteed, its earnings management is even lower. Li Yuanhui and Li Xiao (2018) believe that in the voluntary stage, the real earnings management of companies with internal control audit is low, and the real earnings management of listed companies is reduced after the internal control audit enters the mandatory stage. Zhang Youshang et al. (2017) find that with the continuous improvement of the internal control system, the accrued earnings management declined but the real earnings management rose.

Regarding the improvement of economic efficiency and performance goals, Liu Yifang et al. (2013) use the return on investment and the net profit margin on sales to measure the impact of business efficiency and effectiveness, and find that the disclosure of internal control information is positively correlated with the operating efficiency and effectiveness of listed companies. Compared

with the first disclosure, the positive impact of continuous disclosure of internal control information is greater. Some scholars have conducted research on investment efficiency and investment opportunities. They believe that in voluntary disclosure, the information disclosure of internal control of listed companies has strong motivational selection behavior and the content of internal control information is low. There is no significant correlation between the internal control report of voluntary disclosure and investment efficiency (Yu Zhongbo et al. 2009). In mandatory disclosure, the quality of internal control information is improved. Chi Guohua et al. (2017) find that the information disclosure of internal control deficiency can lead to the serious insufficient investment, which is significantly correlated with the seriousness of internal control deficiency. Lin Zhonggao et al. (2018) dynamically explore the influence of internal control deficiency on investment opportunities of enterprises, and find out that in voluntary disclosure, enterprises that disclose internal control deficiency have more investment chances. In mandatory disclosure, compared with enterprises that fail to disclose, the increment of investment chances of enterprises with the disclosure of internal control deficiency is reduced year by year.

Xie Fan et al. (2016) analyzes the economic results of the disclosure of internal control deficiency in mandatory disclosure, from the realization of five goals of internal control. Some other scholars conduct rich studies on the economic results of the disclosure of internal control information in terms of financing costs (Lin Zhonggao et al. 2017; Zhang Yao et al. 2015), research and development expenditures (Lin Yu'en et al. 2018), auditing opinions (Zhang Yan et al. 2013) and so on.

## 6. Conclusion

This paper first sorts out the transformation of internal control system in China, taking A-share listed companies in Shanghai and Shenzhen in 2010-2017 as the sample, then analyzes the disclosure of internal control self-evaluation report, internal control deficiency and internal control audit report and reviews literatures related to the influencing factors and economic effects of the information disclosure of internal control. It can be found that, first of all, compared with voluntary disclosure, the quality of internal control information in mandatory disclosure is improved. However, there still exist some opportunistic behaviors to hide existing internal control deficiency or downgrade the level of internal control deficiency, with lower content of internal control information. This, on the one hand, requires the supervision departments in China to further complete the system for the disclosure of internal control information and increase the costs for the opportunistic behaviors of listed companies. On the other hand, it requires investors to correctly consider information related to the internal control deficiency disclosed by enterprises, and strengthen the motivations for disclosing internal control information inside and outside. Secondly, impacted by the transformation of internal control system, there is difference in the influencing factors of disclosing internal control information in voluntary disclosure and mandatory disclosure, which will have different impacts on its economic results. Therefore, in future study, it is necessary to take the different stages of sample and analyze its economic results based on different disclosures motivations.

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