



The Impact of Internal Control on the Quality of Corporate Governance from An Audit Perspective

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Abstract. With the further development of the economy and the new situation changes in the post-epidemic period, the importance of internal control, audit and corporate governance is becoming more and more prominent. In order to deal with the continuous economic downturn and slow recovery, this paper conducts an analysis of Chinese researchers on the interrelationship between internal control, internal audit and corporate governance, the current development status and existing problems, and the corresponding solutions in these three aspects. Additionally, this paper proposes the shortcomings of the current research and the possible research directions in the future, so as to help enterprises to improve the level of internal control, internal audit and corporate governance, and to ensure enterprise performance within the economic situation changes and make continuous efforts to achieve the goal of everlasting success. It is hoped that these results can effectively organize previous research and provide constructive suggestions to the related research in the future.

Keywords: Internal control; audit; corporate governance.

1 Introduction

Audit (the main research object of this paper is internal audit), internal control and corporate governance are closely related to each other. The main function of internal audit is to supervise the overall economic management of the enterprise, which is an inseparable part of internal control. Internal audit and internal control are both related to the structural setup of the enterprise, so they are closely related to the content and effect of corporate governance. In addition, the establishment and improvement of the modern enterprise system has already required enterprises to pay more attention to these three aspects of institutional settings. After that, the further development of the market economy and the impact of the COVID-19 crisis on the global economy are all alarm bells for the change of management concepts of enterprises. Companies that had neglected or minimized internal audit, internal control or corporate governance had already been exposed to hidden dangers during the previous period of operation, and the economic blockade between countries and regions as well as the market shutdown brought about by the outbreak of COVID-19 had brought the hidden dangers to the

surface, making the market more competitive. Therefore, the study of the relationship between the three is particularly important in current society.

The relationship between these three has been addressed in traditional studies. Bian pointed out that the primary task of modern internal audit is to strengthen internal control over the department or unit and to establish and improve the internal audit system [1]. The function of internal audit is constantly derived with economic development, from economic supervision to internal control and evaluation of the economic performance of enterprises. Therefore, it can be said that internal audit has promoted the emergence of internal control, or internal audit is the core concept of internal control [1]. Yang and Hu mentioned that since the internal control framework of an enterprise is formulated by the managerial layer and approved by the board of directors, the effectiveness of the internal control system is related to the behaviors of the shareholders and managers, i.e., it is related to the structure of corporate governance [2]. Especially in Chinese enterprises with a high degree of overlap between directors and managers, the design of the internal control system is likely to become a tool for the managers to violate shareholders' rights and for jeopardizing the interests of small and medium-sized shareholders. Therefore, the effectiveness of internal control and corporate governance are complementary and not separate from each other.

In addition to conducting a literature review of previous studies, this paper makes comments and proposes suggestions to future research directions. Changes in the economic situation have led to an increase in the impact of external audit on corporate governance performance, therefore, this paper argues that the study of the impact of internal control and corporate governance quality under the audit perspective needs to add the consideration of external audit, especially social audit. Moreover, due to the time reason, this paper mainly focuses on combing the Chinese literature, which is the shortcoming of this paper, and it is recommended to increase the western literature researches in the future to make this research topic more complete.

2 Concepts Related to Internal Control, Audit & Corporate Governance

In September 1992, the Committee of Sponsoring Organizations(COSO) issued the Internal Control-Integrated Framework, which became the reference standard for the construction of the U.S. internal control framework. The report states that there are five basic elements of internal control, namely, i.e., internal control environment, risk assessment, control activities, information communication, and supervision. The main objectives of internal control are to improve operational efficiency and effectiveness, reduce the risk of loss of assets, and ensure the legitimacy and reliability of financial reporting. The implementation of internal control is oriented to all the company's personnel, including the board of directors, management and grassroots employees. It is a dynamic and orderly control procedure, and the significance of its impact goes deep into the organizational structure, and even corporate culture.

Audit is an independent economic supervisory activity in which a specialized organ reviews the authenticity and legality of major projects and financial income as well as

expenditure of national governments and enterprises at all levels in accordance with the law. It mainly categorized as government audit, social audit and internal audit. The main object of this study is the internal audit. The main target of external audit is generally financial reports and other economic information, while the internal audit in addition to the authenticity of financial accounts, integrity of the review, but also focus on the financial work of the enterprise's authenticity, norms, procedures, as well as evaluation of the correctness of the implementation of the internal control, which is far more than the role of external audit, and even related to the entire internal structure of the enterprise operation, personnel appointments and regulated supervision.

The prominent feature of the establishment of the modern enterprise system is the separation of operating rights and ownership, which leads to the emergence of the principal-agent problem. In the corporate governance model with a decentralized ownership structure, the autonomy of the enterprise's business activities falls largely in the hands of the top management, which is prone to problems such as power imbalance and infringement of shareholders' rights and interests. In a corporate governance model with a centralized ownership structure, in addition to the above problems, there is an inequality of power within the group of shareholders, which results in the infringement of the rights and interests of small and medium-sized shareholders. The general practice of corporate governance is to improve the organizational structure and the distribution of power to achieve checks and balances between shareholders and managers, and between major and small and medium-sized shareholders, so as to achieve the purpose of not only authorizing the operators correctly and making the enterprise operate flexibly, dynamically and efficiently, but also supervising the conduct of the operators and major shareholders, so that they will act in the interests of the majority of the shareholders. The ultimate goal is to maximize shareholders' rights and interests and corporate profits.

3 Overview Analysis

3.1 Relationship Between Internal Control and Corporate Governance

In the above introduction to the models of corporate governance, one knows that corporate governance models can be divided into decentralized ownership structure and centralized ownership structure. The former is the principal-agent problem between the owner and the operator in the traditional sense, where the owner and the operator have the problems of inconsistency of target interests and information asymmetry, which makes the managerial layer lack of supervision and hollows out the owner's actual control over the company. The latter focuses on the conflict of interest between the majority and minority shareholders, where the majority shareholders will not only harm the rights and interests of the minority shareholders for their own interests, but also be prone to maximize their own welfare rather than the interests of the company.

The traditional perspective on the relationship between internal control and corporate governance focuses on decentralizing the ownership structure and puts the emphasis on monitoring and reducing the information gap. Cheng pointed out that the common ground between internal control and corporate governance lies in the

monitoring mechanism, the arrangement of authority and responsibility, and the information communication [3]. At the supervisory level, the supervisory roles of internal audit in internal control and board of auditors (BOA) in corporate governance are independent of each other and mutually restraining. Also, the audit objects of internal audit and themselves are the supervisory targets of the BOA. In terms of the authority and responsibility arrangements, each link and each role in internal control and corporate governance needs to perform its own duties and do a good job of supervision in order to reduce decision-making errors. In the area of communication, horizontal and vertical communication are both required between each department in internal control and between management and shareholders in corporate governance, which have overlapping organizational structures and also belong to the same company as a whole, with the goal of maximizing organizational interests [3]. Therefore, effective information transfer is one of the necessary measures to reduce costs and increase efficiency and correctness of strategic decisions. In addition to this, Beng Wee GOH showed that audit committees and boards of directors play an important role in monitoring and are able to correct self-interested behavior of management [4]. Therefore, the strengthening of the internal control system can compensate for the deficiencies in the corporate governance system.

The passage of time and economic development have made the study of the relationship between internal control and corporate governance supplement the perspective of centralized ownership structure. Yang and Ma showed in their study that good internal control can inhibit the power intensity of large shareholders and their hollowing out behavior when they are hollowing out through capital appropriation and related guarantees. This is because good internal control can improve the quality of information disclosure and reduce information blocking, thus reducing the risk of power concentration by major shareholders [5]. Li and Yan found that institutional shareholding can effectively inhibit the defects of internal control, and the higher the institutional independence, the stronger the inhibition. This demonstrates the validity of the "effective monitoring" hypothesis, that is, external shareholders will actively play the role of voting and election to reduce decision-making errors and increase the supervision of management [6]. Objectively, the ultimate goal of this perspective would also be to reduce the traditional owner-manager principal-agent costs, but it adds the category of corporate shareholders to the study, which is also significant for improvement.

Besides, for the general aspect, a good corporate governance model can enhance the effectiveness of internal control. Cheng and Wang pointed out that the attendance rate of the year-end shareholders' meeting is positively related to the quality of internal control, and the greater the degree of intersection of the authority of the chairman of the board and the general manager, the worse the effectiveness of internal control [7]. Therefore, a sound corporate governance structure in which each department is independent and effectively exercises its authority is one of the requirements for the effective performance of internal control.

3.2 Relationship of Internal Audit to Internal Control and Corporate Governance

In traditional studies, on the relationship between these three, scholars believe that internal audit mainly plays a supervisory role, including the review of financial data and the monitoring of authority behavior between company departments. Chen and Liu suggested that internal audit has an important role in corporate governance in terms of resolving information asymmetry. This function is mainly embodied in the supervision of financial status: internal audit reviews the authenticity of financial statements and other economic information, and has the right to demand full disclosure, which greatly breaks the information gap between company departments and between the company's managers and shareholders, thus reducing the principal-agent costs and promoting the process of corporate governance goals. In terms of the relationship with internal control, the two scholars also specifically suggested that internal audit can effectively detect signs of false financial reporting data and thus improve the internal control structure [8]. Yan and Yang indicated that from the perspective of corporate governance, internal control evaluation is also part of the role of internal audit structure. In addition to ordinary supervisory boards, enterprises with huge business and complex structure should also design BOA and audit departments to give full play to the function of internal audit and improve the corporate governance structure, so as to achieve the purpose of layer-by-layer monitoring and strict structure. The specific internal control framework diagram is shown in Fig. 1 [9].

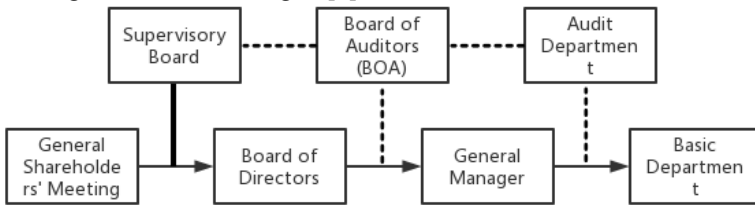


Fig. 1. Internal control framework.

Later, academic research added the external audit perspective to supplement the study of the relationship between these three. An empirical analysis conducted by Chi, Guo and Wang based on the data of listed companies held by central enterprises from 2010-2015 found that internal control deficiencies can be prevented through government audit, which also enhances the standard of company governance. However, due to the hysteresis, the impact on organizations internal control improvement is only felt for two consecutive periods after the audit and leads to limitations on its role [10]. Therefore, the main auditing power to improve the quality of corporate operation still falls on the self-supervision and internal audit, while the work of government audit is only a supplementary external regulation. Through multiple discriminant analysis Getie M D, Amare A M found that external auditors' perceptions of internal auditors' performance are associated with a high intensity of external auditors' reliance on the work of internal audit [11]. They suggested that strengthening internal audit can help improve the link between internal and external audit, thereby increasing the effectiveness of corporate governance [11].

3.3 Current Status

There are general problems with China's internal control system, internal audit system, and corporate governance system. First of all, for internal control, both Huang and Wu agreed that China's internal control system is not perfect and lacks a unified framework of standards and laws and regulations to regulate it [12, 13]. Part of the reason is that China's corporate governance system is still in its infancy and has not yet formed structural guidelines. In addition, the lack of professionalism of internal auditors and the lack of attention to internal control by company managers and decision makers are also the main human factors. In terms of the internal audit system, Lu and Jin believed that China has not raised the importance of internal audit. There is a lack of independence about the internal audit, which is constrained by other departments or higher leadership. It loses the significance of the audit, and even exacerbates the potential crisis of the enterprise. In addition, the general quality of internal auditors in China is low, and there is a lack of unified selection criteria at the root [14].

Finally, on issues relating to corporate governance, the highest decision-making body in the modern corporate system, the general meeting of shareholders, decides on a number of crucial issues for the company, including amendments to the articles of association, the nomination of the board of directors, and significant investment plans. Numerous nations have established legislative norms governing the frequency with which general shareholder meetings of companies must be held as well as the proportion of attendees. Huang pointed out that most of the shareholders' meetings of enterprises in China are empty shells, with a small number of participants and a small number of times of exercising their powers as well. The name remains, but the reality is gone. In addition, Huang argued that there is no check and balance of power among the board of directors, the supervisory board, and the management of enterprises in China, which leads to the abuse of functions and inefficiency. Moreover, there are no clear and standardized guidelines for the selection system of management personnel [12].

3.4 Corresponding Solutions

First of all, enhance the professionalism and independence of auditors, and auditors should be selected, trained and deployed in a uniform manner by the State's auditing department, so as to avoid the internal auditors having other interests related to those within the enterprise, and to maintain their independence and ensure the impartiality and objectivity of their work [14]. In addition to the Supervisory Board, increase the design of the Board of Auditors and Audit Department to ensure that there is supervision of economic behavior and authority to act. Secondly, it is recommended that the state needs to implement a thorough assessment of internal control of businesses by a neutral third party (the government or a third-party non-profit organization) and standardize evaluation indicator systems at the legal and institutional levels [15]. Incorporate the results of internal control quality evaluation into the listing and other rating scores of enterprises to enhance the importance of internal control in firms. Finally, it is suggested that improve the internal governance of the company and

enhance the mutual checks and balances among the general meeting of shareholders, the board of directors, the supervisory board and the management. To prevent a situation where insiders and large shareholders are in control, every effort should be made to maintain a reasonable number of meetings and a high rate of attendance at the general meeting of shareholders. It is a good idea to implement a cumulative voting system, a voting exclusion system for affiliated shareholders, etc., and to increase the proportion of outside shareholders on the board of directors [16].

4 Conclusion

To sum up, in China, there has been literature on the study of internal audit, internal control and corporate governance since the 1990s, and later on, the relationship among the three has also been excavated to summarize the status quo problems and put forward suggestions to solve them. From the time and content, it can be seen that China has paid more and more attention to the correlation between the three, and also increased the refinement of different perspectives. The relationship between the three is positively correlated with each other, and the continuous development of internal audit and the needs of the economic market have extended the internal control system. Compared with internal audit, internal control is more of a system, and the core of internal audit is embedded in it. The effectiveness of corporate governance cannot be separated from the supervision and evaluation of internal control and internal audit, and its continuous improvement in structural independence and power checks and balances also promotes the improvement of internal control. However, China's internal control started late, and it was only in 2011 that the internal control audit business of certified public accountants began to be gradually implemented, and there is a relative lack of experience that can be used as a reference, so the development of China's internal control system has a long way to go.

In addition, in order to cope with the changing environment, it is believed that the scope of the study should be expanded. For example, research on social audit could be added. Audit is categorized into government audit, social audit and internal audit. In the existing literature, there have been major studies on internal audit and the role of government audit added, but social audit has not been extracted from the main body of external audit for more detailed analysis. The audit opinion issued by the social audit has an important reference value for the company's financing, profitability, image and other aspects. At the same time, many businesses that are struggling to make withdrawals and are in debt are suddenly exposed to the public. Although there may be scholars who have seen the slightest thing, they are still a minority. The main reason is that the company issued a financial report and the third-party accounting firm's audit opinion is not abnormal. Is this a case of a company's ability to whitewash its financial reports exceeding the ability of its social auditors to finish their job, or is it a case of a company having an interest in the third-party auditors? If the latter is the case, does the issuance of a standard unqualified opinion leave a buffer for the company to save the day, or does it exacerbate internal control and corporate governance problems? It is

hoped that future scholars will increase their research in this direction and dig deeper into the impact of audit on the quality of internal control and corporate governance.

Although there is relatively little research literature on the relationship between state audit, social audit and internal audit, in the limited information one can find that social audit and internal audit are important supplements to state audit. As for social audit and internal audit, the importance of internal audit should be greater than that of social audit. Because internal audit is related to the structural arrangement and system setting of the enterprise, it can fundamentally find out the deficiencies and make timely decision-making suggestions. And because it is familiar with the economic information and business operation of the enterprise, internal audit often serves as the main counterpart of the government audit and social audit, which facilitates them to conduct external audit on the enterprise. In addition, social audit services need to be purchased, and the level of detail of the work can be determined according to the price, and there is room for maneuver. It is also hoped that future scholars will conduct in-depth research in this area to correctly position the status of internal audit and to help enterprises enhance their awareness of the roles in internal control and corporate governance. Finally, because of the limited research time, this paper mainly focuses on combing the Chinese literature and lacks the reading and summaries of the relevant foreign literature, and it is hoped that this deficiency can be remedied in the future research, so as to make the research on this topic more perfect and increase the promotion of improving the quality of internal control and corporate governance.

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