



Determinants and economic consequences of voluntary disclosure of internal control weaknesses in China



Xu-dong Ji ^{a,b,*}, Wei Lu ^c, Wen Qu ^d

^a International Business School Suzhou, Xi'an Jiaotong-Liverpool University, Suzhou 215123, Jiangsu Province, China

^b Department of Accounting, La Trobe University, Bundoora, Vic. 3086, Australia

^c Department of Accounting and Finance, Faculty of Business and Economics, Monash University, Caulfield Campus, Caulfield East, Vic. 3145, Australia

^d Department of Accounting, Deakin Business School, Faculty of Business and Law, Deakin University, Burwood, Vic. 3125, Australia

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ABSTRACT

This paper investigates the determinants and economic consequences of disclosure of internal control weaknesses (ICWs) by Chinese listed firms under the voluntary disclosure regime over 2010–2011. We find that the probability of firms disclosing ICWs is not only associated with firm characteristics such as profitability, age and business complexity, but is also strongly related to the unique attributes of corporate governance and ownership structure in Chinese listed firms, e.g. the independence of the supervisory board, political connections, concentration of the top 3 shareholders' ownership and tradability of shares.

Our results show that the severity of the ICWs disclosed is negatively and significantly associated with earnings response coefficients (ERCs), and audit assurance of ICRs has a significant moderating effect on the relationship between ICWs and ERCs. Our research adds further evidence to support the implementation of SOX-type regulations globally.

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1. Introduction

In May 2008, The *Basic Standard of Enterprise Internal Control* (*Basic Standard* hereafter) was jointly issued in China by the Ministry of Finance (MOF, 2008), the China Securities and Regulatory Commission (CSRC), the National Auditing Office (NAO), the China Banking Regulatory Commission (CBRC) and the China Insurance Regulatory Commission (CIRC). Three supporting guidelines for implementing the *Basic Standard* were further issued in 2010. The *Basic Standard* and guidelines require listed firms to provide a management evaluation and an auditor's assess-

ment of the effectiveness of their internal control. These regulations only became mandatory from 1 January 2012. Prior to this date, listed firms could elect to comply with these rules voluntarily (MOF, 2010). Our investigations focus on examining the determinants and economic consequences of the voluntary disclosure of internal control weaknesses (ICWs hereafter) in the period 2010–2011.

Many studies have investigated the determinants of ICW disclosure (Ashbaugh-Skaife et al., 2007; Bedard, 2011; Doyle et al., 2007a, 2007b; Ge and McVay, 2005; Ghosh and Lubberink, 2006) and the economic consequences of ICW disclosures from the perspective of equity holders (Ashbaugh-Skaife et al., 2009; Beneish et al., 2008; Hammersley et al., 2008; Ittonen, 2010; Ogneva et al., 2007). These studies focus on firms operating in the institutional environment of the Sarbanes–Oxley Act (SOX) in the US, where the reporting of internal control information is mandatory.

* Corresponding author. International Business School Suzhou, Xi'an Jiaotong-Liverpool University, Suzhou 215123, Jiangsu Province, China and Department of Accounting, La Trobe University, Bundoora, Vic. 3086, Australia. Tel.: 9479 3061; fax: 9479 2356.

E-mail address: x.ji@latrobe.edu.au (X. Ji).

The motivations of firms to disclose ICWs under a voluntary regime can be significantly different from those under a mandatory requirement. According to Deumes and Knechel (2008), in a voluntary setting where there is “no legal obligation to report on internal control”, “such reporting can be considered to be ‘at will’ and reflective of economic and agency incentives” (p.36). Therefore, information released by firms under a voluntary setting is likely to be more reflective and accurate. So far there is little empirical evidence on the determinants and the economic consequences of disclosing ICWs in a voluntary setting except one recent study by Basu et al. (2013).¹ It is for this reason that we choose the voluntary disclosure period 2010–2011 in China as our research timeframe. The objective of our paper is to investigate the determinants, as well as the economic consequences of voluntary disclosure of ICWs in China where the institutional environment is significantly different to that found in the West.

We are particularly motivated to examine the voluntary disclosure of ICWs in China for several reasons. First, most studies have examined these issues in a highly regulated environment, i.e. in the US post-SOX period. Considering that the regulatory environment in China is significantly different in terms of governmental influence and effectiveness of law enforcement mechanisms, research from the Chinese setting may or may not yield similar results to those of US studies.

Second, although the *Basic Standard* is similar to the US SOX, these two regulations are different, especially with respect to the scope of internal control. The *Basic Standard* (also known as the China SOX in the literature) is more comprehensive and extends the scope of the internal control system to much broader business management areas such as organizational structure and human resource (HR) management, while the US SOX particularly focuses on the internal control system related to financial reporting (Bedard, 2011). It is therefore interesting to investigate whether a much broader internal control regulation has any different impact on earnings quality.

Finally, Chinese listed firms have some unique corporate governance and ownership structure characteristics. Many listed firms are heavily influenced by the government through state ownership and political connections (Chen et al., 2010). Listed firms in China have a dual board monitoring system – a board of directors (BOD) and a supervisory board which consists of the representatives of employees and shareholders (Firth et al., 2007; Gul et al., 2010; Oi, 2005; Seung, 2006). We intend to investigate the impact of these unique institutional settings on the voluntary disclosure of ICWs in our study.

In our study, we assume that if a firm has decided to provide an internal control report (ICR hereafter) volunta-

rily, it will disclose all existing ICWs in its ICR. The reason is that once the ICRs are published, they will attract attention from investors, auditors and regulators. More scrutiny may be given to firms that only disclose positive news in their ICRs and there is a high likelihood that firms will be severely penalized by the regulators and market participants if any negative signs are later discovered. To avoid these risks, including litigation risks, firms that provide ICRs will likely disclose all ICWs in their ICRs (Verrecchia, 2001). Given that the sample in our paper comprises firms that have provided ICRs, it is reasonable to assume that our sample firms with no ICWs disclosed in their ICRs do not have ICWs. Our results are summarized as follows.

First, our results show that the severity of ICWs reported by Chinese firms is moderate. Most ICWs are reported in the areas of organizational structure, human resource management, financial reporting, and finance and investment. Second, our results demonstrate that the probability of firms disclosing ICWs in their ICRs is not only associated with firm characteristics such as profitability, age and business complexity, but is also strongly related to the unique Chinese corporate governance ownership structure attributes: the independence of the supervisory board, the political connections of the CEO or the chair of the BOD, the concentration of the top 3 shareholders' ownership and the tradability of shares.

Third, we find that the disclosures of ICWs by firms have significant economic consequences in that the severity of the ICWs negatively and significantly moderates earnings response coefficients (ERCs), and audit assurance of ICRs has a significant influence on the relationship between earnings quality, measured by ERCs, and ICWs. This implies that if firms with disclosed ICWs choose to have their ICRs audited, then earnings informativeness can be improved.

Our study makes some significant contributions in a number of ways. First, it is one of the few studies providing empirical evidence on what the determinants and economic consequences of ICW disclosure are in a voluntary setting. Second, it shows that the disclosure of ICWs has a moderating effect on earnings quality and that the audit assurance of ICRs takes effect only when firms disclose ICWs in their ICRs. Finally, our study has policy implications globally. Even though the benefits and costs of implementing the US SOX are still being debated (Ashbaugh-Skaife et al., 2009; Dhaliwal et al., 2011), many countries have, nevertheless, gone ahead and implemented the US SOX-type of regulations, giving rise to problems such as adding extra disclosure burdens to firms. There is thus an urgent need to understand the possible consequences of applying such a regulation in a very different regulatory environment. Our results show that there are positive outcomes associated with the disclosure of ICWs even in a different regulatory environment such as that of China. We find that adequate internal controls within firms can lead to high quality financial reporting which, in turn, improves earnings quality.

The remainder of the paper is organized as follows. Section 2 provides the disclosure requirements of internal control in China. Section 3 discusses the theoretical framework and provides a literature review and hypothesis development. Section 4 outlines the research design while

¹ In a working paper, Basu et al. (2013) investigated the economic determinants and consequences of voluntary disclosure of internal control effectiveness by using a sample of IPO firms in the US. Their results show that IPO firms with higher litigation risk are more likely to disclose ICWs voluntarily. They also find that IPO firms proactively disclose ICWs and remedy plans have lower underpricing. Their results suggest that the voluntary disclosure of ICWs is an effective mechanism to reduce information asymmetry.

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