

SUSTAINING COMPETITIVE ADVANTAGE THROUGH GOOD GOVERNANCE AND FISCAL CONTROLS: RISK DETERMINANTS IN INTERNAL CONTROLS

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Abstract

How to cite this paper: Rahman, M. J., & Marjerison, R. K. (2020). Sustaining competitive advantage through good governance and fiscal controls: Risk determinants in internal controls. *Corporate Ownership & Control*, 18(1), 34-46.
<http://doi.org/10.22495/cocv18i1art3>

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ISSN Online: 1810-3057

ISSN Print: 1727-9232

Received: 17.05.2020

Accepted: 10.09.2020

JEL Classification: G34, M42, D53

DOI: 10.22495/cocv18i1art3

This study conducts a comprehensive review of the literature published during 1989-2020 to identify the factors that can cause internal control weakness. This review is organized around five main groups, namely: 1) rapid growth and restructuring, 2) financial reporting complexity, 3) auditor tenure, 4) cultural differences, and 5) corporate governance. We perform an integrated literature review approach. Among the several factors found, some factors (the proportion of managerial ownership, Individualism, power distance, financial reporting complexity, rapid growth, and auditor-customer geographic distance) have a positive relationship with internal control weakness while others (the quality of the board of directors and auditing committees, directors' compensation, and uncertainty avoidance) have a negative relationship. The findings contribute to future research by examining the factors that can cause internal control weakness from different perspectives, which will prove to be useful for investors, auditors, audit committee members, managers, and other stakeholders regarding the prevention of internal controls weaknesses through the application of solid internal controls as well as a path towards the improvement of existing problems of internal control weakness.

Keywords: Corporate Governance, Cultural Differences, Financial Reporting Complexity, Growth and Restructuring, Internal Control Weakness, Auditor Tenure

Authors' individual contribution: Conceptualization -M.J.R. and R.K.M.; Methodology - M.J.R.; Formal Analysis - M.J.R. and R.K.M.; Investigation - M.J.R. and R.K.M.; Writing Original Draft - M.J.R.; Writing - Review & Editing - M.J.R. and R.K.M.; Supervision - M.J.R.; Project Administration - M.J.R. and R.K.M.

Declaration of conflicting interests: The Authors declare that there is no conflict of interest.

1. INTRODUCTION

The importance of internal controls is a factor in firm performance is well established (Lai, Li, Lin, & Wu, 2017). Firm performance in the absence of strong internal controls can be negatively affected

by any of several factors, weaknesses in internal controls is a major contributing factor in the presence of fraudulent activity (Gonzalez & Hoffman, 2018; Hamdani & Albar, 2019; Zakaria, Nawawi, & Salin, 2016). Weak internal controls have been found to have adverse implications firm

engaged in acquisition related activity (Harp & Barnes, 2018), and may have a significant effect on decisions made by users of financial information (Chalmers, Hay, & Khlif, 2019). A relationship between internal control weaknesses and operational control risk has been reported by Lawrence, Minutti-Meza, and Vyas (2018), and a similar relationship was found between internal controls and operational efficiency (Cheng, Goh, & Kim, 2018).

Internal control weaknesses are found to result in increased information uncertainty which may negatively affect the cost of capital for the effected firms (Beneish, Billings, & Hodder, 2008). Firms with internal control weaknesses are more likely to experience financial difficulties in the form of a stock price crash (Kim, Yeung, & Zhou, 2019). Importantly, financial reporting fraud by managers is found to be more prevalent in firms with internal control weaknesses (Donelson, Ege, & McInnis, 2017).

Awareness and an understanding of the factors that cause internal control weakness is an important first step in addressing those weaknesses and ultimately improving firm performance. In an exploration of the relationship between internal controls and firm performance, this study seeks to build on the important work of Doyle, Ge, and McVay (2007a), supported by the findings of recent related research. In that paper, researchers determined that there are seven factors associated with internal control weakness. The study uses a summarized listing of those factors which is supplemented with other factors identified from related literature and also shown to impact weaknesses in internal controls.

In various literature, researchers have analyzed the factors that impact internal control weakness from different perspectives. A review of the literature on related research gives us a greater understanding of the problems and helps us to identify gaps in their collective research. Thus, we can develop a direction for this and subsequently further research to build on earlier findings.

The objective of this study is to conduct a comprehensive literature review to identify the factors that play a part in the presence of weak internal controls, analyze how they impact the internal control process, and suggest methods to improve internal control. This study utilizes an integrated literature review approach. The integrated literature review is a summary of the previous literature and offers a comprehensive understanding of a specific problem (Whittemore & Knafl, 2005; Tranfield, Denyer, & Smart, 2003). Articles from various resources were examined, including journal databases, libraries, and professional accounting websites. To find target articles, we used terms such as corporate governance; cultural differences; financial reporting complexity; growth and restructuring; internal control weakness; auditor tenure. Previous research that was examined was prioritized based on relevance and date with emphasis placed on manuscripts published from 1989 to 2020. As studies in this area are abundant, several studies are found and selected for analysis. The availability of prior studies helps us choose only the factors that have a significant co-relationship with internal control weakness. We organize our review around five main groups, namely: 1) rapid growth and restructuring, 2) financial reporting

complexity, 3) auditor tenure, 4) cultural differences, and 5) corporate governance.

Earlier studies reveal that the existing literature on the factors causing internal control weakness has been examined from different perspectives. Among the several factors found, some factors (the proportion of managerial ownership, Individualism, power distance, financial reporting complexity, rapid growth, and auditor-customer geographic distance) have a positive relationship with internal control weakness while others (the quality of the board of directors and auditing committees, directors' compensation, and uncertainty avoidance) have a negative relationship with internal control weakness.

This study contributes to the literature in the following manner. Firstly, a review of manuscripts published during 1989-2020, thereby presenting a comprehensive overview of the literature on the factors that cause internal control weakness. Secondly, the inclusion of studies conducted in various international settings, including the United States, the European Union (EU), Japan, Indonesia, Saudi Arabia, and Australia. Thirdly, the findings are summarized and suggestions for future research from different perspectives are suggested. This study will be useful for investors, auditors, audit committee members, managers, and other stakeholders regarding the prevention of internal controls weaknesses through the application of solid internal controls as well as a path towards the improvement of existing problems of internal control weakness.

The remainder of this paper is organized as follows. Section 2 consists of a comprehensive review of the literature to identify the factors that can cause internal control weakness. Further research, theoretical contribution, and concluding remarks are integrated into Section 3.

2. LITERATURE REVIEW

2.1. Rapid growth and restructuring

According to Doyle et al. (2007a), rapid growth is a characteristic that impacts internal control weakness. The same and related research also found that rapid growth had a positive relationship with internal control weakness (Caplan, Dutta, & Liu, 2018; Gul, Fung, & Jaggi, 2009). Rapid growth is often calculated by spending on mergers and acquisitions and extraordinarily high sales growth, high acquisition value, and high sales growth are indicators that a corporation has experienced rapid growth (Yasuda, 2005). Restructuring frequently results in debt acquisition and firms with internal control weakness have been found to face higher costs associated with incurring debt (Li, Lou, Otto, & Wittenberg Moerman, 2016). The data showed that materially weaker companies had higher acquisitions value and higher sales growth (Doyle, Ge, & McVay, 2007a, b). In summary, the findings indicated that rapid growth had a positive relationship with internal control weakness.

There are some explanations for the positive relationship between rapid growth and internal control weakness. If a company grows rapidly, it needs better internal control systems than a company that is experiencing slow growth, however, it takes time to rebuild the internal control systems

(Kinney & McDaniel, 1989). Therefore, there is likely to be a gap between the fast-growing corporation and a suitable internal control system. In order to rebuild the internal control system, corporations need suitable employees, planning, and technology. The lag time and resources needed to ramp up the internal control processes often leads to a gap period during which there is internal control weakness (Thompson & Wright, 1995). Rapid growth was also strongly related to the level of engagement and activity of the board of directors because the rules, process, the structure of internal control and board tended to lag behind during periods of rapid growth (Beasley, 1996). These findings indicate that rapid growth would influence corporate governance in a negative way and result in less effective internal controls.

Beasley (1996) found that a gap between corporate performance and management capacity can continue for up to two years subsequent to a period of rapid growth and that though rapid growth indicates may show that the corporation performed well, the growth resulted in circumstances which necessitated a high level of active engagement by management. Beasley (1996) also found that if the corporation had been experiencing rapid growth, the management was more likely to alter the financial statements during the weak performance period in order to show healthy growth. This resulted in the potential motivation for the corporation to put forth fraudulent financial reports. As a result, auditors should pay particular attention to identify irregularities in the financial statements that show stable performance during periods of rapid growth.

According to Doyle et al. (2007a) restructuring is a determinant that impacts internal control weakness. In that study, restructuring included both mergers and acquisitions as either can impact the relative effectiveness of internal control. The same research found that restructuring would likely lead to internal control weakness. In their research, the level of restructuring that a corporation underwent was measured by restructuring charges. These and related findings showed that companies determined to be materially weaker had higher restructuring charges (Denis & Kruse, 2000; Doyle et al., 2007a).

There are some explanations for the positive relationship between restructuring and internal control weakness. Firstly, restructuring often results in a reduction in the headcount of departments decreasing the number of experienced and qualified employees (Doyle et al., 2007a). Often restructuring caused serious issues related to staff, resulting in more internal control weaknesses. Secondly, because of the disorder during and after restructuring, the internal control system must be renewed to suit the operation of the new organization. Thirdly, restructuring often resulted in many complex accrual estimations increasing the importance of internal controls the importance of inventory, more frequent losses, and that the possibility of financial dilemmas increased.

Thus, auditors should concentrate on corporations that are in the process of restructuring or have recently been through the process of restructuring. Those corporations that are in the process of restructuring are more likely to have internal control weaknesses. Auditors should focus

on the reduction of deficiencies. For example, because increased attention triggered by the presence of restructuring charges, Nortel Networks was found to have an internal control weakness in the area of lacking complete procedures for adjusting and detecting balances (Doyle, Ge, & McVay, 2007b).

Summary: There is compelling evidence to support the relationship between the complexity of financial reporting and internal control weaknesses, particularly in cases where the reporting complexity is caused by or related to geographic location (distance), new types of transactions, currency exchange transactions, multi-national regulatory requirements, decentralization, and creations of special accounts. It is also apparent that researchers need a more standardized and representative process and definition of factors to measure the complexity of financial reporting. After analysis and examination of the factors above, the relationship between financial reporting complexity and internal control weakness is compelling, but specific recommendations to mitigate these weaknesses are not forthcoming in the existing literature. A logical next step for research in this area would be to explore remedies.

2.2. Financial reporting complexity

Financial reporting complexity is a factor that has been found to impact internal control weakness (Rahman & Fang, 2019; Doyle et al., 2007a). Financial complexity can be measured by the reporting of special purpose numbers, the reported segments numbers, and the existence of foreign currency transactions. The audit process is a communication between the auditor and those stakeholders that will have cause to use or have access to the audit report (Kusaila, 2018). The report itself is not a financial report, but an assessment of the reliability and validity of the financial statements. More complex financial reports result in additional complexity in the assessment of the accuracy of the reports for auditors (Kusaila, 2018). There has been found to be a positive relationship between financial reporting complexity and internal control weakness. In other words, the more complex the financial report, the more likely the weakness of internal control.

It is expected that higher internal controls will be needed to deal with emerging types of transactions and there is some consensus in the research on that expectation (Ibrahim & Yaya, 2005; Zhang & Cahan, 2010). There is a general consensus that the regulatory environment will vary from place to place and particularly in the case of a multinational company will result in increased complexity of reporting (Elbakry, Nwachukwu, Abdou, & Elshandidy, 2017; Laughlin, 2007; Omer, Bedard, & Falsetta, 2006; Rahman, 2015). When calculating the deferred tax provision, the methods of calculating can be complex (Lymer & Hasseldine, 2002; Miller & Oats, 2016; Yasseen, Jansen, & Small, 2016). Company business diversification and complex operations create difficult regulatory compliance issues (Alsmairat, Yusoff, Salleh, & Basnan, 2018; Wang, 2020; Doyle et al., 2007a) used three measurements to examine complexity; the log of reported special purpose numbers, a log of the reported segments number and the existence of foreign currency transactions. A regression analysis shows that the high level of complexity leads to

complex transaction results and in turn to internal control material weakness.

The complexity of financial reporting is related to the presence and use of special accounts (Russell, Milne, & Dey, 2017) and it has been found that a relationship between account complexity and potential lack of oversight exists (Hoitash, Hoitash, & Yezegel, 2017; Hoitash, Hoitash, & Bedard, 2009). It has also been found that company decentralization may increase the likelihood of internal control problems (Doyle et al., 2007a). If decentralization increases the likelihood of internal control problems, then from the company's perspective, the company may not be a good candidate for a strategy of decentralization. In the market, companies with complexity issues tend to be smaller companies, frequently experiencing financial problems, and also tend to have a high level of diversification in their business activities (Putra, Sumadi, & Pratiwi, 2018).

Before 2002, auditors did not need to disclose internal controls to the public but the Sarbanes-Oxley Act in 2002 prompted the first time that internal controls were required by the SEC to be disclosed to the public. Internal control then became a part of shareholder communications (Hoitash & Hoitash, 2009). Financial reporting is also of concern to shareholders. According to Bushman, Chen, Engel, and Smith (2004) and supported by the findings of Raghunandan, Rama, and Read (2001) board size and the limit of the percentage of inside directors' directly impacted the complexity of financial reporting. The same study also reported that the decentralization strategy increases the internal control weakness.

The positive relationship between the financial reporting complexity and internal control weakness requires companies that have a high level of reporting complexity to increase the level of oversight to maintain sufficient internal controls. Additionally, based on the above-related findings, smaller companies that have more business diversification should invest more resources in the oversight of internal control.

The findings reached in this study are concluded by use of specific measurements based on the work of Doyle et al. (2007a), where only the number of reported special purpose, the number of the reported segment, and the existence of foreign currency transactions were considered to represent the complexity of financial reporting. There remain several other factors that have been found to impact the complexity of financial reporting. In the work of Doyle et al. (2007a) geographic location is only mentioned briefly, but in the study conducted by Ashbaugh-Skaife, Collins, and Kinney (2007), the complexity of financial reporting can be measured by the geographic and/or product line diversification. In this study, it was found that the geographic location did have an impact on internal control. Other research on the topic includes that of McEwen and Hunton (1999) who put forward the premise that the speed of the diffusion of information will be affected by the complexity of information. Therefore, the financial reporting complexity will affect the diffusion speed, and thus will affect the degree of internal control. Additionally, McEwen and Hunton (1999) also indicate that traditional financial reporting has been made more complex by the need to measure new types of transactions. Their research considers this problem but does not give recommendations of

a specific measurement to resolve this problem. In conclusion, researchers need a more standardized and representative factor to measure the complexity of financial reporting. After analysis, the relationship between financial reporting complexity and internal control weakness is compelling, but specific recommendations to mitigate these weaknesses are not forthcoming. A logical next step for research in this area would be to explore remedies. Recently, Rahman, Zhang, and Dong (2019) report that some factors (experience of the analyst, earnings quality, audit quality, IFRS adoption, and annual report readability) have a positive relationship with the accuracy of analysts' forecasts while others (politically connected firms, firms audited by non-Big 4, and international GAAP differences) have a negative relationship.

Summary: The more complex the financial report, the more likely the weakness of internal controls. However, the financial report audited by an external auditor reduces the complexity of internal control. There is a general consensus that the regulatory environment will vary from place to place and particularly in the case of a multinational company will result in increased complexity of reporting. It has also been found that company decentralization may increase the likelihood of internal control problems. The Sarbanes-Oxley Act in 2002 prompted the first time that internal controls were required by the SEC to be disclosed to the public. Internal control then became a part of shareholder communications.

2.3. Auditor tenure

Audit quality is related to internal controls and is known to have a positive effect on firm performance (Rahman, Ying, Zhu, & Ji, 2020; Haislip, Peters, & Richardson, 2016). There are several factors contributing to quality audit performance with auditor tenure one of them (Garcia-Blandon & Argiles-Bosch, 2017; Patterson, Smith, & Tiras, 2019). The research of Chen, Gul, Truong, and Veeraraghavan (2016) focused on the audit quality and cluster theory and documented the relationship between the auditor tenure, geographic proximity of the auditor to the client (proxies for auditor client-specific knowledge), and the incidence of Section 404 internal control weakness (ICW) under the Sarbanes-Oxley Act of 2002 (Pub.L. 107-204, 116 Stat. 745) (United States, 2002). With a large sample of 24,217 annual observations for the period 2004-2012, their findings indicate that companies with longer auditor tenure and closer geographical proximity to auditors have a smaller chance of ICW. In addition, it was found that the positive correlation between auditor-customer geographic distance and internal control weakness is weaker for companies that have longer auditor's tenure (Chen et al., 2016). The results also indicate that the auditor rotation policy may deprive the auditor of specific knowledge of the customer, especially for auditors who are based farther away from their clients.

Since the notable financial scandals in recent years, the issue of auditor and auditor-client relations has attracted attention from policymakers, practitioners, and academics. In several jurisdictions, including the United States, the issue of auditor rotation and partner tenure remains unresolved (Daugherty, Dickins, Hatfield, & Higgs, 2012). The Public Company Accounting Oversight

Board (hereafter PCAOB) publicly endorsed the view that rotation would increase the independence of auditors and lead to better auditing quality. In the 2011 concept release, the PCAOB proposed the reasons for mandatory auditor rotation on the grounds that it would improve the independence of auditors. However, the American Chamber of Commerce and some members of the US Congress do not give auditor rotation support Horton, Livne, and Pettinicchio (2020) primarily because it raises costs for auditing and deprives corporate of specific knowledge about customers (Rapoport, 2012).

Although in general, a lot of evidence suggests that auditors with short tenure have low audit quality due to lack of customer-specific knowledge (Gul et al., 2009, Gul, Ma, & Lai, 2017; Myers, Myers, Palmrose, & Scholz, 2004). Other studies indicate positive correlations with audit quality or no correlation (Cameran, Prencipe, & Trombetta, 2016; Daugherty et al., 2012). Some studies have shown that auditors that have longer tenure can provide auditing services that are of higher quality because auditors need time to develop customer-specific knowledge to give effective auditing (Hamilton, Ruddock, Stokes, & Taylor, 2005; Horton et al., 2020). Geiger and Raghunandan (2002), Gul et al. (2009) and others found that auditors with longer tenure are associated with a higher quality of both revenue and reporting failures (Kyriakou & Dimitras, 2018). Johnson, Khurana, and Reynolds (2002) reported that the issues related to accruals for the auditor's with short tenure (2-3 years) were higher than the ones with median tenure (4-8 years).

Companies that are closer to the auditor's geographic location present lower internal control issues. The auditor's tenure and geographic distance can have a significant effect on the account-specific (or transaction level) reporting and company-level internal control weakness. Most interestingly, researchers found that the positive correlation between auditor-customer geographic distance and internal control weakness is weaker for auditors with longer tenure, which means that the auditor's tenure may alleviate weak customer-specific knowledge resulting from a geographical distance (Chen et al., 2016). This discovery also echoes key information from Ashbaugh-Skaife et al. (2007) that indicates that changes of auditors may deprive auditors of specific customer-specific knowledge, especially for auditors who are far away from customers.

Ideas about the relationship between geographic location and customer-specific knowledge are not new (Chen et al., 2016; Choi, Kim, Qiu, & Zang, 2012). The cluster theory that developed in organizational research shows that close geographic proximity contributes to community network sharing for firms in close geographic proximity. Social networks promote a higher level of social, informational, and message exchange among actors in the area (in this case, auditors and clients). In addition, cluster theory argues that companies within geographical proximity will strengthen trust-building, thereby limit opportunistic behavior, such as earnings management and failure to perform good internal control procedures. Some researchers endorse the view that geographic proximity promotes cooperation between companies (auditors and clients) and strengthen trust between them (Lorenzen & Foss, 2003).

Networks, social interaction, and exchange relations, which lead to trust, can also bring knowledge and learning of companies in the same geographic area (Nohria & Eccles, 1992). For example, managers and auditors often discuss business issues during formal and informal social meetings, which can lead to knowledge and learning, in this case, of strong internal controls. It's also important that social roles (auditors and clients) in the network may act in a non-opportunistic manner, mainly because they want to maintain the trust of others in the network, rather than build their own reputation (Calton & Lad, 1995). The interdependence of knowledge bases between auditors and customers is key to new ideas and innovations through a variety of trust-based exchange relationships (Patrucco, 2003).

These findings are built on previous research which suggests that a few important factors of an enterprise are related to internal control weakness. For example, Ashbaugh-Skaife et al. (2007) found that companies with more complex operations, recent changes in the organization, greater risk in accounting, more auditors resigning, and fewer resources for internal control are more likely to be related with internal control weakness. Doyle et al. (2007a) suggest that the size of the company, the age of the company, the financial health situation, the complexity of financial reporting, rapid growth, restructuring costs, and corporate governance are related to ICW. Krishnan (2005) and Hoitash et al. (2009) found that audit committees with better quality corporate governance are associated with a lower incidence of internal control issues and Ashbaugh-Skaife et al. (2007) study found that more auditors' resignations were associated with an increase in the incidence of internal control weakness, which is consistent with the view that auditors with short-term tenure may be associated with higher internal control weakness.

Summary: Audit quality is related to internal controls. Companies with longer auditor tenure and closer geographical proximity to auditors have a smaller chance of ICW. A social network is also an important factor for internal control. Managers and auditors often discuss business issues during formal and informal social meetings, which can lead to knowledge and learning, in this case, of strong internal controls. Companies with more complex operations, recent changes in the organization, greater risk in accounting, more auditor turnover, and fewer resources dedicated to internal control are more likely to experience internal control weakness. Audit committees with better quality corporate governance are associated with a lower incidence of internal control issues.

2.4. Cultural differences

According to Kanagaretnam, Lobo, Ma, and Zhou (2016), cultural differences are influential in the possible presence of internal control material weaknesses (ICMWs), a related study by Irawanto (2018) found that national culture plays an important part in the creation of fraud prevention. Culture can refer to national culture or organizational culture, both of which have implications for audit firms (Andiola, Downey, & Westermann, 2020; Sari, Lubis, Maksum, Lumbanraja, & Muda, 2018). Individualism,

uncertainty avoidance, and power distance, the three dimensions of culture defined by Hofstede (2011), are the areas discussed in this section.

Higher individualism is an indicator of more ICMWs. In the environment of higher individualism, managers are more likely to have a higher level of motivation to manage earnings because they are rewarded according to the company's performance (Kanagaretnam et al., 2016). This, in turn, results in the increased possibility that risk-taking is also present at a higher level and therefore more likely to occur. Shupp and Williams (2008) argued that the variance of risk preferences for individuals is usually greater than that of groups. Willing to take more risks, decision-makers tend to behave with more individualism and with less concern for other shareholders' benefits. According to Kanagaretnam et al. (2016), during the financial crisis from 2007 to 2008, banks, where higher levels of individualism were present, were more likely to incur a larger loss, which indicates a higher level of confidence in the relationship between individualism and risk-taking.

On the one hand, more risks indicate that the efficiency and effectiveness of operations in a company could be negatively affected because the operational decisions could be made less carefully and with fewer checks and balances that come with collective decision making. On the other hand, management may not design a strong enough internal control system to mitigate the risk of fraud or error, because they do not take the characteristics of the whole firm into consideration. On the contrary, the internal control system designed by the managers might refer to their own styles and thoughts. Compared with collectivist cultures, individualist cultures show more attention to self-interest instead of group objectives that are above personal (Alzeban, 2015).

Prior literature provides mixed evidence on whether good corporate governance leads to better firm performance (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 2002; Klapper & Love, 2004; Durnev & Kim, 2005; Core, Guay, & Rusticus, 2006; Bhagat, Bolton, & Romano, 2008). It is universally acknowledged that self-interest is not always consistent with collective benefits. Both the possibility and the opportunity that members in a company may engage in fraudulent activity is higher if the organizational and social cultures are highly individualistic (Suryanto, Thaib, & Mulyati, 2019). Based on their findings, it can be said that self-interest is one of the important factors for the conflict of interests with shareholders of the company. In contrast, a cultural perspective suggests that the very definition of "good" corporate governance practices is influenced by national culture, and thus the optimal set of corporate governance practices could vary across countries (Griffin, Guedhami, Kwok, Li, & Shao, 2014). They conclude that national culture matters in firms' adoption of corporate governance practices, and that within countries, there is a largely positive association between firm-level corporate governance practices and firm performance; however, across countries, the association is largely negative.

While high individualism leads to a weakened internal control from management and the resultant increase in operational risk, An, Cao, Chen, and Li (2020), individualism is also likely to increase as a

result of internal control weaknesses. However, Griffin et al. (2014), find that the national cultural dimension of individualism is positively associated with transparent disclosure and explicit corporate policy. The cycle is established under the conditions where individualism is high at the same time internal control is weak, consequently auditors should both collect more evidence to reduce detection risk in case of fraud or error, and, managers through awareness of the relationships should also ensure that the level of individualism into taken into consideration.

Uncertainty avoidance, as ascertained through assessment of stability and risk reduction, also affects the existence of ICMWs. Low uncertainty avoidance means that the level of risk that people are willing to accept is higher, compared with high uncertainty avoidance where people tend to behave less prudently. Therefore, it can be said that the above correlates seriously with the theory of asymmetric information and its possible influence of decision making by the managers and further conflicts of interests with shareholders. For example, accounting potentially reduces information asymmetry through disclosure. Therefore, national culture, especially as expressed in individualism and uncertainty avoidance (to the extent they manifest in accounting values) has an impact on the cost of equity capital. Simply put, good-quality accounting attracts investors and influences managers' decision making (Hope, 2003). Borker (2012) investigates the impact of cultural values on IFRS in central and eastern European countries revealed that IFRS were considerably more difficult to implement in cultures like that of Russia than in Germany and Scandinavia. Thus, national culture can help or prevent countries from absorbing the benefits of IFRS adoption, including improved financial reporting quality and transparency and reduced information asymmetry, risk, and cost of equity capital (Borker, 2012).

Therefore, companies with low uncertainty avoidance have more inherent risk in internal control. As is discussed above, the work of Kanagaretnam et al. (2016) found that some banks had to face a larger loss, which was of lower uncertainty avoidance, which is persuasive evidence that uncertainty avoidance is an appropriate index of risk-taking. Additionally, according to the findings of Kanagaretnam et al. (2016), the preference of fewer risks in high uncertainty avoidance environment results in higher accounting quality, as there will tend to be fewer opportunistic managerial behaviors. It should be acknowledged that high uncertainty avoidance is not definitely beneficial for a company, but in accounting aspects, the avoidance of risk influences the prediction of future accounts, which makes a difference on the quality of financial statements. Moreover, higher uncertainty avoidance means that in the presence of a stricter managing and operating style, the number of mistakes is reduced. As a result, uncertainty avoidance is negatively associated with ICMWs.

The third of the factors related to cultural differences is power-distance which is shown to positively influence ICMWs. Corruption, a problem that leads to the imbalanced distribution of wealth and resources, is a result of power distance to some extent. Power distance is a signal of inequality. People living in an environment of high-power

distance accept the inequalities of power, while people with low power distance are more likely to fight and denounce corruption (Kimbrow, 2002). Therefore, in a low power distance environment, the defense from corruption is stronger, and supervision is also more effective.

Compared with a company with a culture of high-power distance, the low-power-distance company is more likely to discover and more likely to solve a problem in a timely manner (Chan, Lin, & Mo, 2003). Moreover, in companies of lower power distance, employees work more independently which results in increased efficiency of work, and more importantly, the employees are less likely to engage in fraudulent activities and more likely to report errors in financial reports (Bik & Hooghiemstra, 2018; Smith & Hume, 2005). The possibility of material mistakes is reduced under such conditions, so lower power distance could help to mitigate the existence of ICMWs.

The three dimensions of cultural differences do have an impact on internal control weaknesses. Individualism and power distance are positively related to ICMWs (Caban-Garcia, Figueroa, & Petruska, 2017), while uncertainty avoidance is negatively associated with ICMWs. To remediate internal control weaknesses, Li, Sun, and Ettredge (2010) pointed out that firms should hire highly qualified senior finance managers and CFOs, and Johnstone, Li, and Rupley (2011) found that companies with more experienced CPAs are more likely to remediate. Duggar (2009) delved into the important role of personal integrity in corporate leadership but the challenges associated with reliable data assessing and validating the aspects of integrity place this consideration outside the scope of this study. Auditors should be free from the three dimensions of cultures of their client companies, but they could observe and analyze the internal control of the company according to their cultural differences.

Summary: Within the context of this study, culture can be considered to be either national or organizational. Using the widely known and accepted dimensions of culture as defined and expanded upon by Hofstede (2011) it was found that while individualism and power distance positively influence ICMWs, there is a negative relationship between uncertainty avoidance and ICMWs. For those companies with cultural characteristics that show a high potential or possibility of fraud or error, the auditor should examine a higher percentage of sample supporting materials in order to reduce detection risk, and therefore reduce the audit risk.

2.5. Corporate governance

Strong internal controls evidenced by the internal control function are considered to be a prerequisite for good governance (Raiborn, Butler, Martin, & Pizzini, 2017). Brown and Caylor (2006) report that corporate governance is valued by Institutional Shareholder Services (ISS). Their research used 51 ISS factors to calculate governance effectiveness. If a firm's shareholders were satisfied with the factors, the firm scored 1 point, if not; they scored a 0 for that category. These 51 factors were divided into 8 parts: board of directors, bylaws, audit committees, directors' education, ownership, state

of incorporation, progressive practices, executive and directors' compensation, including both external governance and internal governance. Based on how the board of directors' and auditing committees' characteristics, ownership structure, executive and director' compensation influence ICMW, their findings indicate that there is a negative relationship between good corporate governance and ICMW.

In prior studies, the board of directors' quality is defined by size, independence, meeting frequency, and a number of directors held by non-executive directors (Carcello & Neal, 2003; Hoitash & Hoitash, 2009; Seawright, 2018). Xie, Davidson, and DaDalt (2003) found that accrual quality is associated with a board of directors' independence and Beasley (1996) reported that the number of independent directors is negatively associated with financial statement fraud. Hoitash et al. (2009) found that supervisory financial expertise has a positive effect on the quality of the management process and the controls on personnel and information technology. Park (2019) found that the likelihood of litigation resulting from audit activity was reduced when more outside directors were included on audit committees. The level of the busyness of audit committee members has been found to have an impact on the quality of a firm's internal controls, Hua, Leaby, and Liu (2016) and the perceived reliability of audit reports as reflected in the value of a firm's none cash assets with director busyness defined a serving on the audit committees of boards of multiple non-related firms (Kim, Guo, & Yang, 2018). The quality of the board of directors will enhance the effectiveness and quality of monitoring and reduce the likelihood of ICMW.

Auditing committees are often closely related to the presence of an operating board of directors, which in turn is responsible for oversight of internal controls, therefore auditing committees are an important part of corporate governance. Auditing committees' directors are responsible to monitor, communicate, and evaluate management in accounting, financial reporting, and internal control (Xie et al., 2003). The audit committee's quality is defined by the percentage of members that are independent of management (at least three members), and the presence of at least one member with expertise in finance (Raghunandan et al., 2001). Firms with auditor committees' members who are professionals in the area of finance have fewer internal problems, and there is a negative relationship between independent numbers in auditing committees and ICMW (Krishnan, 2005). The independence and relevant experience and knowledge of the audit committee membership plays a major role in the quality and effectiveness of internal controls.

Ownership is another important determinant in ICMW. There are there various kinds of ownership: institutional ownership, managerial ownership, and block holder's ownership each with its own advantages and disadvantages in terms of internal controls. Institutional investors are important in oversight activity and play an active role in protecting their significant stakes in investment companies (Lin, Xiao, & Tang, 2008). Based on a study by Ashbaugh-Shaife et al. (2007), because of increased regulation and threats of litigation by institutional investors, companies with higher a

higher level of institutional investment ownership are more motivated to discover and disclose internal control deficiencies. Other research finds that some institutional investors may not focus on disclosing ICMW, they may only focus on profit gathering (Lin, Hutchinson, & Percy, 2009; Pucheta-Martinez & García-Meca, 2014).

In recent years there has been an increase in the relevance of shareholders in the corporate governance of firms Connelly, Shi, and Zyung (2017) with a trend towards information-based activism Jefferies (2019), and an increased focus on corporate social responsibility broadly inclusive of environmental issues and creation of non-financial value (Camarena-Martinez, Ochoa-Silva, & Wendlandt-Amezaga, 2016; Wójcik, 2016).

Notwithstanding CSR relative activism, the positive effect of shareholder engagement, or activism in corporate governance as a driver of financial performance has been well established in recent research Herciu and Șerban (2016), Birkmose (2017), and particularly in more developed economies (Ojeka, Fakile, Ikpefan, & Achugamonu, 2016). Further, there is a well-established relationship between CSR and financial performance. Akben-Selcuck (2019) reports that greater concentrations of firm ownership are likely to increase shareholder activism in CSR related activity and subsequently result in more favorable financial performance. Shareholder activism is frequently associated with CSR related activities (Gómez-Bezares, Przychodzen, & Przychodzen, 2017) and is consistently found to improve the financial performance of the firm (Hasan, Kobeissi, Liu, & Wang, 2018; Hoepner, Oikonomou, Sautner, Starks, & Zhou, 2019; Nollet Filis, & Mitrokostas, 2016; Rahman & Luo, 2020). Using Chinese data, Rahman and Fang (2019) also find that corporate social responsibility has a significantly positive effect on firm performance in China. Using ordinary least squares (OLS) regression to analyze data from the sample of 123 U.S. chemical firms from 2009-2018, Rahman and Luo (2020) finds that KLD index has a significantly positive impact on CFP, while TRI index does not have a significantly impact on CFP.

Shareholder influence is often exerted by institutional investors and can influence firm decision-making including joint venture engagement (Connelly, Shi, Hoskisson, & Koka, 2019), director nomination (Campbell, Campbell, Sirmon, Bierman, & Tuggle, 2012), and compensation plan structure of upper-level management (Brandes, Goranova, & Hall, 2008; Ferri & Oesch, 2016).

Influence may be exerted by stakeholders other than shareholders (Cundill, Smart, & Wilson, 2018), while it is well known that customers and employees Guo, Huang, Zhang, and Zhou (2016) have an influence on financial performance, it has also been demonstrated that these two groups of stakeholders are influenced by external reports, specifically regarding Corporate Social Responsibility activities of the firm Akisik & Gal (2017), resulting in an increased importance of audit and other externally produced reports.

Managerial ownership means the top management of the firm own shares and has partial ownership of the companies that they manage while blockholder ownership is when one investor owns

a large block of a company's shares and/or bonds. Managerial and blockholder ownership is negatively associated with voluntary disclosure (Eng & Mak, 2003). The higher proportion of managerial and block holders' ownership the higher the likelihood of ICMW.

Executive and directors' compensation also affect the monitoring of management. The independence of directors will enhance the compensation and shareholders' welfare, which causes a stronger incentive to monitor. Deep-rooted managers have a significant impact on directors' compensation, which leads to contracts that provide directors with weaker incentives to act for the benefit of shareholders (Ryan & Wiggins, 2004). The weaker incentives to monitor will increase the likelihood of ICMW.

Executive compensation is also an important part of corporate governance. The compensation of CEOs has been found to be related to the tenure, or seniority of CFOs (Liu, Ouyang, & Sun, 2018). The CEO's compensation is positively related to the percentage of the outside directors who are appointed by the CEO and higher CEO compensation is related to less stringent corporate governance (Core, Holthausen, & Larcker, 1999).

Summary: In general, the lack of independence of the board of directors and auditing committees, combined with a high proportion of managerial ownership and lower directors' compensation will result in a higher likelihood of the firm developing ICMW.

3. CONCLUSION

In conclusion, this project explores five factors that would have an influence on the internal control weakness. Firstly, cultural differences influence internal control material weaknesses, including individualism, uncertainty avoidance, and power distance. While individualism and power distance positively influence ICMWs, there is a negative relationship between uncertainty avoidance and ICMWs. Secondly, there is a negative relationship between good corporate governance and ICMWs. Thirdly, companies with longer auditor tenure and closer geographical proximity to auditors have a smaller chance of ICMWs. Fourthly, material weakness companies had higher acquisitions value and higher sales growth, which indicates that rapid growth had a positive relationship with internal control weakness. Finally, there is a positive relationship between financial reporting complexity and internal control weakness.

According to Corley and Gioia (2011), there are two parts to a theoretical contribution: originality and utility. Originality is the presence of some incremental and revelatory insight. In this paper, new determinants of weakness in internal control were not put forth, the theoretical contribution, therefore, lies in the analyses and summarizing of the prior studies' findings which are in different fields, including culture, corporate governance, financial reporting, and organizational restructuring. The integration of the prior researcher adds to the body of knowledge in the area of internal control weakness.

This research meets the requirement of utility; it has both practical and scientific use. Scientifically, this paper makes a comprehensive summary of the

prior studies about how different aspects of corporate governance influence ICMW and those findings can help policymakers, those involved in both external and internal audit functions, as well as other stakeholders to understand how corporate governance can influence the internal control system and help establish a better policy for monitoring internal control and reduce ICMW. Practically, this finding points out the importance of culture, corporate governance, auditor's tenure, and corporate structure, which can help managers to establish better internal control systems. The findings can also help to identify those firms with material weakness or those that are at elevated states of risk and serve as a guide for investors seeking to avoid firms where such elevated risk may be present.

It is important to note that the purpose of a literature review is not just to summarize what is currently known about a topic, but is also to provide a detailed analysis and discussion of the interconnection of the previous research, in the case of this study, across disciplines. Frequently studies of this nature include the examination of case studies which could serve to support the specific findings, however due to practical limitations the inclusion of case studies was determined to be outside the scope of this study.

In this research, some of the factors found to influence internal control weakness are examined and explored. However, there remain unanswered questions; for example, the research does not explore which factors are more powerful in

influencing internal control weakness. As an example, a comparison of rapid growth and cultural differences, which factor is likely to have a greater influence on internal control weakness? Other areas deserving further investigation are the casual effect relationships between the factors and how the factors may interrelate and influence each other including the role of ethics in audit, which while related is a broad and separate area of inquiry. Other further research could examine in detail the relationship between culture and internal control weakness and a comparison of internal control weakness in organizations across different national cultures. The role of organizational culture could also be explored in detail as a factor in both the frequency and type of internal control weakness.

Due to increasing activity by shareholder activists research on the relationship between internal control weaknesses and shareholder influence is worthy of further exploration. Related to shareholder activism is the relationship between the influence of non-investor stakeholders and internal control weakness which due to its relatively recent emergence is an area that is underexplored in the existing literature.

In order to improve internal weakness, auditors and management should realize the factors which impact the internal control weakness and focus on those areas. However, probably the most important question arising from this research is which of the factors investigated could most efficiently be addressed, to provide the most powerful impact in the reduction of internal control weakness.

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