

CURRENT KNOWLEDGE ON INTERNAL CONTROL: A LITERATURE REVIEW

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Outline of the presentation

- Background
- Internal controls systems
 - Concept of IC
 - Drivers of ICFR quality
 - Consequences of ICFR weaknesses
- ICFR and the audit
 - Auditors reliance in ICFR
 - Auditors opinion on ICFR
- Research opportunities

Background

- FAR Research project (2018) – Auditor judgment on internal control quality and audit quality
 - Research questions
 1. What factors influence the auditor's evaluation of client internal control quality?
 2. What is the effect of auditor evaluation of internal control quality on the audit procedures?
 3. What is of perceived client internal control quality and subsequent audit procedures on financial statements adjustments?
- Literature review

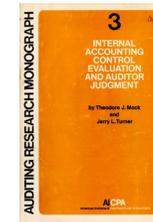
Historical perspective

- The 1970

1. audit failures → IC received attention from the U.S. Congress (FCPA), regulators and the business press.
2. Rapid technological change and competitive pressures → audit firms were interested in research to make the audit more effective and efficient.

- Research

- Mock & Turner's AICPA Monograph – Internal accounting control evaluation and auditor judgment (1981).
 - Significant variability in decisions, process, recommendations, interpretations of IC.
- Peat, Marwick, Mitchell & Co (now KPMG) SEADOC – System Evaluation Approach, Documentation of Controls (1983). Abandoned and moved toward the Business Management Process (BMP) in the mid 1990.
- Bédard (1986) Internal control evaluation in computerized systems: Experts versus novices.



- The 2000

- New audit failures → SOX 404

Internal control

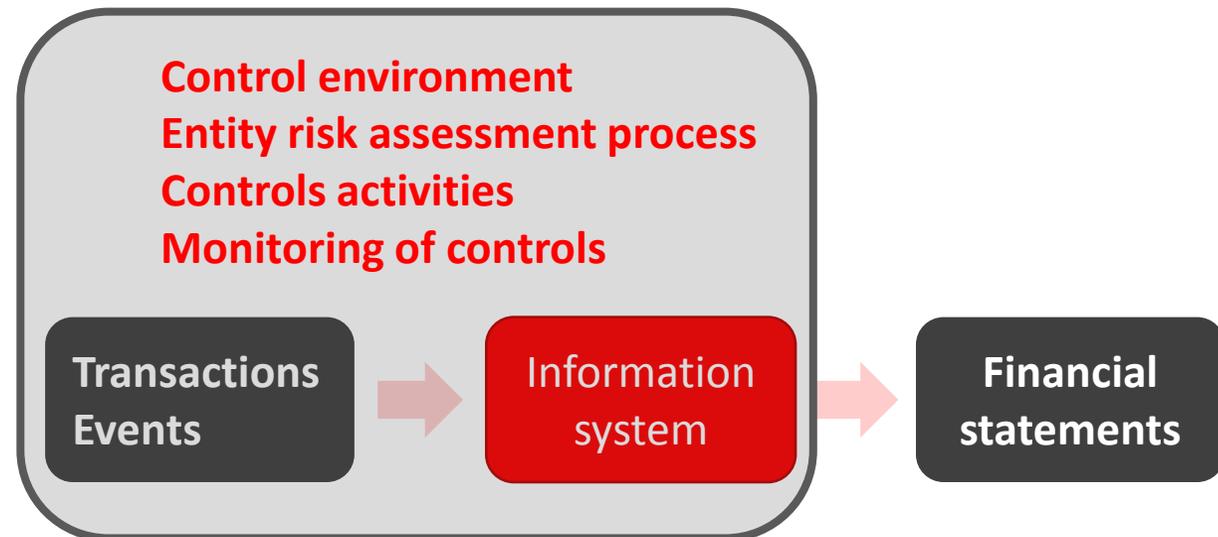
Definition

IC— “a **process**, effected by an entity's board of directors, management and other personnel, designed to **provide reasonable assurance** regarding the achievement of objectives relating to operations, reporting and compliance” (COSO, 2013).

ICFR – to provide a “reasonable assurance about the reliability of a company’s financial reporting and its process for preparing and fairly presenting financial statements in accordance with GAAP” (PCAOB, 2004).

Components

- Control environment
- Entity risk assessment process
- Information system
- Controls activities
- Monitoring of controls



Research on Internal control



Internal control weakness (ICW)

- **Material weakness**

- deficiency, or a combination of deficiencies, in ICFR, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.

- **Types of internal control weaknesses**

- Account specific weaknesses
- Company wide weaknesses

Drivers of ICFR 'non' quality

Drivers

Firms operations
Executives
Audit committee
Board of directors



Drivers of ICFR 'non' quality

- Firm's operations
 - Complexity (+)
 - Diversification (+)
 - Size (-)
 - Age (-)
 - Financial distress (+)
 - External capital need (-)
 - Data breaches (+) (Lawrence et al. 2018)
- Governance environment

Drivers of ICFR 'non' quality (2)

- **Executives**

- CEO characteristics (age, gender, tenure)
- CEO incentives (ownership, social capital)
- CFO characteristics (expertise) and incentives (ownership)

- **Audit committee**

- Independence (exchanges rules, compensation, equity, ties)
- Competence (accounting expertise, supervisory)
- Size and activity

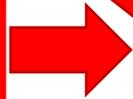
- **Board of director**

- Independence – les ICMW disclosures
- Size

Impact of material weaknesses disclosure

Drivers

Firms operations
Executives
Audit committee
Board of directors



Disclosed ICFR
material
weaknesses



Impact

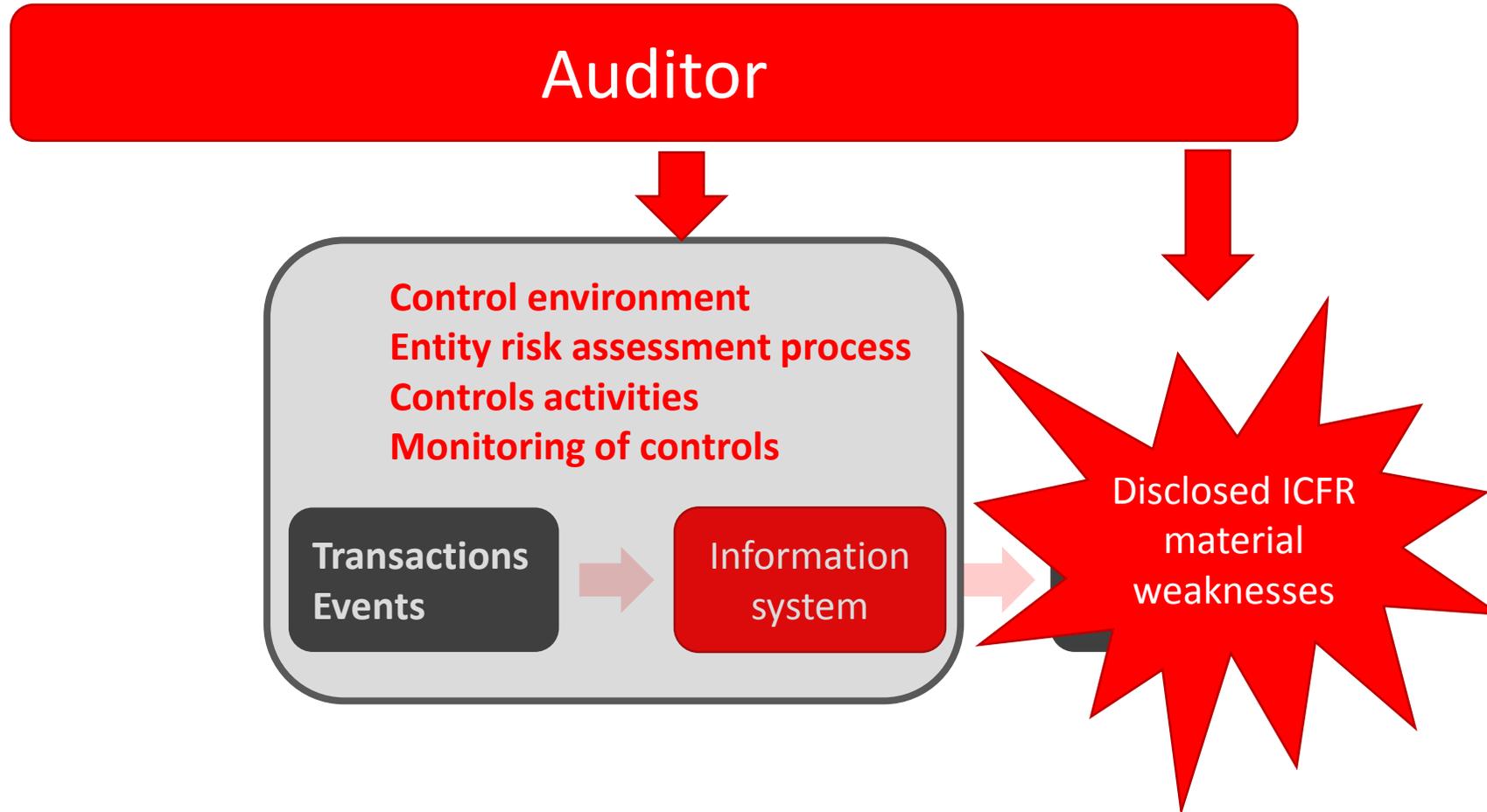
Financial statements quality
Firms operations
Financial markets

Financial
statements

Impact of material weaknesses disclosure

- Financial statements quality
 - Abnormal accruals
 - Meet or just beat analysts' earnings forecasts
 - Restatements
 - Forecast accuracy
- Operations
 - Investment efficiency
 - Higher inventory turnover ratios and inventory impairments
 - Reduction in investments, in particular the risky components
- Audit
 - Higher audit fees
 - Audit report lags
- Market reaction
 - Cost of equity , credit and loan spreads – mixed results

The auditor and the internal control



Auditor and ICFR

- **Financial statements audit**

- Reliance on internal controls and effect on substantive procedures
- Significant variability in decisions, process, recommendations, interpretations of IC
- Role of auditor competence (experience, training, knowledge)
- IC documentation

- **ICFR audit /disclosure**

- Managers' interaction with auditors
- Non audit services
- Better detection/ disclosure of material weaknesses when ICFR is audited

Future research

- Interrelation between the various actors (management, board, auditors) with regard to the quality of internal control systems and the identification/reporting of material weaknesses
- Auditors judgment regarding IC evaluation and its impact on substantives procedures
- New tools for IC evaluation (data analytics)
- Disclosed ICW
 - What about IC quality
 - disclosed ICW ≠ ICW, need non public data about IC quality (both company and audit firms)
- Should ICFR be audited? If yes, at what frequency?
- The US is one of the 195 countries in the world

*Thank you for your
attention*