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The Importance of Internal Controls

SMU Associate Professor Goh Beng Wee investigates the benefits and consequences of internal controls to corporate organisations.

AsianScientist (Feb. 26, 2015) - By Yamini Chinnuswamy - In 2001, a scandal involving former US energy giant Enron Corporation broke out and shocked the world with sordid tales of how its management had exploited the company's lack of robust internal controls to conceal staggering amounts of debt. Enron's mismanagement not only led to its collapse but also that of its auditor Arthur Andersen, which until then had been one of the "Big Five" accounting firms.

The saga highlighted the importance of internal controls—processes that organisations put in place to ensure that corporate objectives are met under the conditions of reliable financial reporting and compliance to laws in companies. According to Associate Professor Goh Beng Wee from the Singapore Management University (SMU) School of Accountancy, such controls range from segregation of duties, authorisation of transactions, retention of records to physical safeguards.

In 2002, the Sarbanes-Oxley Act was passed in the US to curb poor internal control systems. However, the Act was met by fierce resistance from companies that were reluctant to be saddled with additional processes.

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Demonstrating the worth of internal controls

In one of his studies conducted with Professor Dan Li from Tsinghua University, Professor Goh examined how internal controls correlate with accounting conservatism. The latter was argued to increase the usefulness of financial statements by imposing stronger verification requirements for economic gains than for economic losses, thereby reducing the likelihood that firms overstate net income.

According to Professor Goh, firms with a strong internal control environment (e.g., strong tone-at-the-top and/or good internal control culture) are more likely to understand the role of conservatism in contracting and in reducing agency conflicts. Conversely, to the extent that firms are committed to produce conservative reports, strong internal controls can facilitate this process. This is because by emphasising verifiable outcomes, the financial reporting system supplies a rich set of variables that can be used for contracting purposes. By reducing unintentional errors in the reporting of book value or accounting earnings, strong internal controls thus provide more comfort to the board of directors, such that conservatism has been used effectively for contracting purposes and in monitoring managers.

> "We found that firms which exhibited internal control weaknesses tend to be less conservative with their financial reporting. However, when they remediate their internal control weaknesses, accounting conservatism appeared to have increased," shares Professor Goh who specialises in research on the value of internal controls to companies, investors and policy makers.
>
> "Our finding that strong internal controls incentivise firms to be conservative in their financial reporting, instead of overstating accounting numbers to look good, should be of high relevance to investors."

In another study, Professor Goh found that internal controls had implications beyond simply improving a firm's financial reporting. Although such controls were expensive to put in place, he found that they benefitted operational efficiency.

> "Many critics have questioned whether the perceived benefits commensurate with the high costs of implementing stringent internal reporting requirements," he notes. "Surveys and anecdotal evidence have indicated that such measures would place heavy burdens on companies, particularly small firms, as they would struggle to cope with the increased costs of compliance, implementation and auditing."

In consideration of these concerns, Professor Goh, together with fellow colleagues Professor Qiang Cheng and Professor Jae Bum Kim, use a method known as frontier analysis to investigate the relationship between internal controls and operational efficiency. Although less commonly applied to accounting research, this methodology has been used extensively in operational management to evaluate the organisational efficiency of firms.

> "We found that effective controls also improved operational efficiency," notes Professor Goh. "In fact, smaller companies and those that have more uncertain and poorer information environments are likely to benefit more from effective internal controls, at least in terms of improving their operational efficiency."

Internal controls in Singapore

So far, Professor Goh's work on internal controls has focused on firms based in the US. While he is interested to extend his research focus to Singapore, he is constrained by a lack of data in the local context because firms here are not required to report on internal controls systems. External auditors are also not required to audit these mechanisms or provide opinions on them.

> "Although auditors in Singapore do look at internal controls as part of the regular audit process, the purpose is to determine how much substantive testing (i.e., procedures used for checking a random sample of transactions for errors and comparing account balances to find discrepancies) will be needed in the audit. Any internal control weakness that is detected by the auditors will have to be communicated in writing to the firm's management or the audit committee. However, it is not compulsory for the firm to report this weakness in its financial reports or to follow up on it," says Professor Goh.

The main reason for the lack of internal controls provisions in Singapore is due to cost issues, he notes.

> "It is very costly for firms to apply strong internal measures and for time-constrained auditors to conduct checks."

He thinks that the absence of Enron-like sagas in Singapore indicates the presence of effective self-regulating mechanisms here.

> "However, there remains a risk that internal controls within firms are not robust and this may put investors or shareholders at a disadvantage," he cautions.

Creating value with integrated reporting

Even if Singapore does not go the way of regulating internal controls, there is a new area of quality assurance called integrated reporting, which Professor Goh would like to investigate in the future.

According to the International Integrated Reporting Council (IIRC), an integrated report communicates how an organisation's strategy, governance, performance and prospects create value in the short, medium and long terms in the context of its external environment.

> "Integrated reporting is broader than financial reporting and value creation is a key feature. An integrated report includes aspects such as sustainability; for example, how a company contributes to social responsibility as well as its workers' health and well-being," says Professor Goh.

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Given the high cost of producing an integrated report (which in part is due to its broad scope), he thinks that cost-benefit tradeoffs would be a primary concern to many people.

> "I think local financial regulators and accounting bodies will be keen to know whether integrated reporting is a worthwhile endeavour for firms here. This is an area that I would like to conduct research on," he enthuses.

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