https://doi.org/ 10.7251/EMC2202462P

UDK: 005.584.1:657.633

Datum prijema rada: 1. novembar 2022.
Submission Date: November 1, 2022
Datum prihvatanja rada: 15. decembar 2022.
Acceptance Date: December 15, 2022

Časopis za ekonomiju i tržišne komunikacije
Economy and Market Communication Review

Godina/Vol. **XII** • Br./No. **II**
str./pp. 462-475

PREGLEDNI NAUČNI RAD / OVERVIEW SCIENTIFIC PAPER

DETERMINANTS OF THE QUALITY OF INTERNAL CONTROL OVER THE FINANCIAL REPORTING SYSTEM

Amira Pobrić | PhD,Associate Professor,University of East Sarajevo, Faculty of Economics Brčko, amira.pobric@gmail.com, ORCID ID: 0000-0001-8902-7223

Abstract: *External stakeholders rely heavily on the information contained in the financial statements when making business decisions. Given the risks they take in making decisions based on this information, they expect the management to provide them with quality financial statements. In order to be able to provide such financial statements, the company's management needs to establish quality internal control over the financial reporting system. The task of this internal control is to reduce the risks of unintentional errors in accounting records, as well as intentional manipulation of accounting information contained in financial statements. Having in mind the importance of internal control for providing reliable financial statements, the author intends to identify the determinants of the quality of internal control in this article. In order to identify these determinants, the author relies on the results of empirical research conducted in countries where companies are required to disclose information on the quality of internal control over financial statements. According to the author's findings, the quality of internal control is influenced by a number of factors concerning the characteristics of corporate governance and the characteristics of the company in which internal control is established. When it comes to the characteristics of corporate governance, the quality of internal control over the financial reporting system is affected by the quality of the board of directors, the quality of the audit committee and the quality of internal audit. When it comes to the characteristics of the company, the author found that the quality of internal control over the financial reporting system is influenced by the ownership structure of the company, its size, age, financial stability, complexity, growth rate and the fact that the company is in the process of restructuring.*

Key words*: internal control over the financial reporting system, board of directors, audit committee, internal audit, company's characteristics*

JEL classification: *M21, M41*

INTRODUCTION

In the last two decades, the confidence of investors and other external stakeholders in financial statements has been largely damaged. Numerous accounting scandals that occurred at the beginning of the 21st century mostly contributed to this situation. Irregularities were found in the financial statements of large companies such as Enron, WorldCom, Adelphia Communications, Parmalat, Skandia, etc., which caused serious economic consequences for the owners, creditors, employees and, in general, the economies of the countries in which these companies operated. Among numerous criticisms levelled at these companies, regarding their financial reporting, there was a charge that they did not establish adequate internal control and that this led to the irregularities in their financial statements (Agrawal & Chadha, 2005; Verschoor, 2002). Concerns have been expressed that managers do not pay enough attention to establishing quality internal control, which creates room for fraud and errors reflected in the financial statements. This has led accounting practitioners and researchers to focus on issues related to internal control. They are trying to determine how internal control affects the quality of financial reporting and how to establish adequate internal control.

Internal control consists of policies and procedures designed to provide reasonable assurance that specific objectives of the company will be achieved, that any adverse event or occurrence will be prevented, or that the consequences of such events or occurrences will be promptly identified and eliminated. By establishing internal control, the management strives to achieve three broadly defined goals related to: reliable financial reporting, effectiveness and efficiency of operations and the compliance of operations with laws and other regulations. The management of the company is responsible for the establishment and implementation of internal control.

External stakeholders will have more confidence in the reliability of the company's financial statements if the management proves that it performs adequate internal control over the financial reporting system. Therefore, regulatory bodies in some countries, such as the United States, Canada, Japan, and China, have imposed an obligation on companies, primarily listed companies, to assess the effectiveness of their internal control over the financial reporting system and to inform the users of financial statements about the results of the assessment. In the countries where there is no such obligation, companies can report on the effectiveness of internal control voluntarily. On one hand, reporting on the effectiveness of internal control over the financial reporting system contributes to the creation of confidence of external stakeholders in financial statements and, on the other hand, it encourages managers to improve internal control of the company.

In order for managers to be able to establish internal control that will ensure quality financial reporting, it is necessary to identify the determinants of the quality of internal control. This is the issue we are dealing with in this article. At the beginning of the article, the importance of internal control for improving the quality of financial reporting is pointed out by showing how internal control affects the quality of financial reporting. Then, the attention is focused on the most important determinants of the quality of internal control over the financial reporting system. These determinants relate to the characteristics of corporate governance and the company in which internal control is established. Specifically, the impact of the characteristics of the board of directors, audit committee and internal audit is considered, as well as the impact of the company's ownership structure, the size of the company, its age, financial stability, complexity, growth rate and the fact that the company is in the process of restructuring.

THE IMPORTANCE OF INTERNAL CONTROL FOR ENSURING THE QUALITY OF FINANCIAL REPORTING

Internal control over the financial reporting system consists of policies and procedures that should provide reasonable assurance that the financial statements are reliable and that they are prepared and presented in accordance with the applicable financial reporting framework. These are policies and procedures for keeping accounting records, authorizing transactions by the management, and the safeguarding of assets. The task of internal control over the financial reporting system is to reduce the risk of making unintentional errors in accounting records, as well as intentional manipulating of accounting information contained in financial statements. This means identifying all risks of unintentional errors and manipulations in the financial statements, formulating control policies and procedures that can eliminate or at least reduce these risks, and applying those control policies and procedures properly.

Inefficient or weak internal control can lead to the creation of financial statements that do not give a true and fair view of the financial situation and results of the company. Internal control is ineffective if it does not allow management and employees to prevent or detect misstatements in accounting records and financial statements on a timely basis within normal performance of assigned tasks. Internal control will be ineffective if certain control policies and procedures necessary to achieve control objectives are missing, if existing control policies and procedures are not properly designed so that even if properly implemented, they will not meet control objectives, and if properly designed policies and procedures are not applied as provided, i.e., if the person applying them does not have the knowledge and skills necessary for effective implementation of the control (PCAOB, 2004).

Empirical research provides evidence that effective internal control increases the quality of financial statements (Doyle, Ge, & McVay, 2007a; Ashbaugh-Skaife, Collins, Kinney Jr, & LaFond, 2008). (Ashbaugh-Skaife, Collins, Kinney Jr, & LaFond, 2008) proved that effective internal control reduces unintentional errors in financial statements, while (Donelson, Ege, & McInnis, 2017) empirically confirmed that effective internal control reduces the risk of fraud in financial statements. Strong internal control provides better opportunities for detecting and deterring frauds. Thanks to this, investors and other external stakeholders can be provided with more reliable information which increases their confidence in financial statements. On the other hand, inefficient or weak internal control leads to poor-quality financial statements and the provision of unreliable accounting information to external users (Doyle, Ge, & McVay, 2007a; Ashbaugh-Skaife, Collins, Kinney Jr, & LaFond, 2008; Donelson, Ege, & McInnis, 2017). Further, it results in making suboptimal decisions by the users of financial statements (Darrough, Huang, & Zur, 2018), increased cost of capital and debt (Ogneva, Subramanyam, & Raghunandan, 2007; Dhaliwal, Hogan, & Wilkins, 2011), inefficient capital allocation (Lai, Liu, & Chen, 2020) and the like.

Effective internal control can provide reasonable assurance that the financial statements will be reliable, i.e., assurance that there is only a small probability that misstatements in the financial statements will not be prevented or detected in a timely manner. Empirical research confirms that this is sufficient to improve the quality of financial statements and increase the confidence of investors and other external stakeholders in financial statements (Doyle, Ge, & McVay, 2007a; Ashbaugh-Skaife, Collins, Kinney Jr, & LaFond, 2008). Considering that the confidence of external stakeholders in the reliability of financial statements has numerous positive economic consequences, in the form of increased availability of sources of funding, reduced cost of capital and debt, efficient allocation of capital and the like (Ogneva, Subramanyam, & Raghunandan, 2007; Elbannan, 2009), managers should be interested in improving the quality of internal control over the financial reporting system. The owners expect it from them. In order to improve internal control, it is necessary to identify the factors that significantly affect its quality.

THE ROLE OF THE BOARD OF DIRECTORS AND THE AUDIT COMMITTEE IN IMPROVING THE QUALITY OF INTERNAL CONTROL OVER THE FINANCIAL REPORTING SYSTEM

It is believed that the board of directors and audit committee have an important role in ensuring the quality of internal control over the financial reporting system. They contribute to the creation of an environment in which this control is realized (Krishnan, 2005). The board of directors is responsible for monitoring management activities in order to protect the interests of the owners. Managers often exploit weaknesses in internal control in order to pursue personal interests that are not in the best interests of the company and its owners. Therefore, the board of directors takes responsibility to provide monitoring over internal control to improve its quality. The board of directors delegates the task of internal control monitoring to the audit committee.

The audit committee oversees internal control over the financial reporting system by reviewing internal accounting procedures and controls. It communicates with accounting staff, management, internal and external auditors, and the board of directors about their assessment of internal control in order to assure that appropriate controls are in place. Particular attention is paid to the consideration of material weaknesses in internal control. When material weaknesses are detected, audit committee usually requests recommendations from internal and external auditors on how to remove these weaknesses and ensure that management implements the defined recommendations.

The management may not be willing to invest time and resources in eliminating material weaknesses in internal control. When there are material weaknesses in internal control, the management has greater opportunities to behave opportunistically. Also, the efforts to eliminate material weaknesses in internal control divert attention and resources from core activities. However, an effective board of directors and audit committee can put pressure on the management to invest in eliminating material weaknesses and improving internal control (Goh, 2009).

If the board of directors and audit committee are expected to oversee the company's internal control, then it seems likely that a high-quality board of directors and audit committee should be associated to a quality internal control. A high-quality board of directors and audit committee are likely to have a greater influence on managers and their activities regarding internal control over the financial reporting system. The results of empirical studies suggest that high-quality board of directors and audit committee can improve the quality of financial reporting by ensuring timely elimination of material weaknesses in internal control (Goh, 2009). Having in mind the abovementioned, the question arises as to what constitutes a quality board of directors and audit committee.

The relationship between the characteristics of the board of directors and the audit committee and the quality of internal control over the financial reporting system has been investigated. The impact of the size, composition, independence and frequency of meetings of the board of directors and the audit committee on the quality of internal control has been considered.

Research confirmed that the independence and size of the board of directors have a positive effect on the quality of internal control (Chen, Knechel, Marisetty, Truong, & Veeraraghavan, 2017; Hu, Yuan, & Xiao, 2017; Yazawa, 2015). The board of directors is independent if the majority of the members are external directors. Members of board of directors who are independent in relation to the company and its management are more interested in effective monitoring of management activities in order to prevent its opportunistic behavior.

In the literature on corporate governance, the size of the board of directors is observed as a relevant mechanism that can improve corporate transparency (Khlif & Samaha, 2016). A larger board of directors has a greater range of different knowledge, experience and opinions at its disposal. This can increase the efficiency of the activities of board of directors, including internal control monitoring. Thus, the size of the board of directors affects the internal control quality.

Furthermore, research documented that audit committee independence, size, expertise, and meeting frequency are associated with the quality of internal control (Chalmers, Hay, & Khlif, 2019; Lisic, Neal, Zhang, & Zhang, 2016; Khlif & Samaha, 2016; Michelon, Bozzolan, & Beretta, 2015; Goh, 2009; Zhang, Zhou, & Zhou, 2007; Krishnan, 2005). It is typical for companies that have an independent audit committee to eliminate material weaknesses in internal control in a timely manner. This suggests that a more independent audit committee is less susceptible to inappropriate management influence and that it is more likely that such an audit committee will put pressure on the management to remove material weaknesses in internal control.

The efficiency of the audit committee is positively related to its size. A large audit committee tends to improve its status and power within the organization and to receive more resources for its activities. Increased resources and improved status make the audit committee more efficient in fulfilling its oversight role (Zhang, Zhou, & Zhou, 2007). The larger audit committee is likely to be more involved in the management process and to deal with internal control in a more comprehensive way. Therefore, it can be expected that a large audit committee will contribute more to improving the quality of internal control than a small one.

As previously mentioned, the expertise of the audit committee is related to the quality of internal control. The audit committee expertise implies that accounting and financial experts are included as members. In order to be able to oversee internal control, the audit committee needs to have the knowledge necessary to understand the financial reporting system and the control procedures established over this system. Members who have more knowledge in the field of accounting and finance are able to detect material mistakes in financial statements. They are more likely to understand assessments of internal and external auditors and to support the auditors in disputes with the management (Zhang, Zhou, & Zhou, 2007). Consequently, audit committee members with accounting and financial expertise can perform their oversight roles more effectively. They contribute to the efficiency of the overall audit committee.

Thus, problems with internal control are less common in companies that have an audit committee with more accounting and financial experts.

The audit committee may consist of a large number of members who are independent and who have knowledge and experience in the field of accounting and finance and still be inefficient because it does not meet often. The number of audit committee meetings is commonly considered a measure of diligence (Hoitash, Hoitash, & Bedard, 2009). It may reflect how active the audit committee is in overseeing internal control. Audit committee will not be effective if it is not active. Audit committee meetings represent the best place for directors to discuss any financial reporting and internal control problems in order to identify solutions and undertake corrective actions (Khlif & Samaha, 2016). Fewer meetings can indicate a lack of commitment and insufficient time for effective monitoring. Problems identified in the financial reporting or internal control may not be resolved in a timely manner because the frequency of audit committee meetings is low.

It is theoretically and empirically confirmed that the efficiency of the board of directors and the audit committee can be an important determinant of the quality of internal control. However, it should be borne in mind that a powerful CEO may reduce the efficiency of the board of directors and the audit committee. A CEO who has great power has the ability to influence the appointment of the members of board of directors and audit committee. He can advocate the appointment of friendly external members and passive internal members (Chalmers, Hay, & Khlif, 2019). Also, a powerful CEO may provide distorted information to board of directors and audit committee members. Independent members depend heavily on the company's CEO and management for the information they need to perform their duties. Managers are less inclined to share information with members of the board of directors and audit committee due to concerns that they will use such information to increase their oversight of management. With less information, even an independent and expert board of directors and audit committee cannot monitor effectively (Lisic, Neal, Zhang, & Zhang, 2016). Consequently, a powerful CEO may compromise the ability of the board of directors and audit committee to oversee the financial reporting system and internal control over this system. It follows that the CEO's power minimizes the influence of the characteristics of the board of directors and the audit committee on the quality of internal control.

THE IMPACT OF INTERNAL AUDIT ON THE QUALITY OF INTERNAL CONTROL OVER THE FINANCIAL REPORTING SYSTEM

Internal audit refers to the independent, objective analysis and assessment of practices, processes and methods applied in the company. The aim of this analysis and assessment is to identify problems and inefficiencies that exist in the company and to suggest corrective actions. Internal auditors provide managers with analyses, assessments and recommendations regarding the activities that have been audited and thus assist them in carrying out their responsibilities. It can be said that internal audit helps the company achieve its goals by introducing a systematic approach to assessing and improving the efficiency and effectiveness of the company's business operations (Dellai & Omri, 2016).

Internal auditors can perform a wide range of activities in the form of assessing the efficiency and effectiveness and providing consulting services to the management.

The subject of internal audit can be any activity that is realized within the company. However, the primary task of the internal audit department is to monitor and detect weaknesses in internal control and report them to the top management to ensure that corrective actions are taken in a timely manner. Although the ultimate responsibility for establishing and maintaining internal control, as well as assessing its effectiveness, lies with top management, the role of internal auditors is to support management in performing these responsibilities (Oussii & Taktak, 2018).

The top management and the audit committee expect that internal auditors will conduct an audit and gather enough information to be able to make a judgment about whether internal control is functioning as intended. Internal auditors should review and assess the adequacy of accounting, financial and other operational controls. They should affirm the application of controls that are effective and that cause reasonable costs. In this way, internal audit contributes to improving the quality of internal control. Accordingly, it is considered that the quality of internal audit affects the quality of internal control in the company (Fadzil, Haron, & Jantan, 2005).

External auditing standards have acknowledged internal auditing as a potentially valuable resource in the financial reporting process (PCAOB, 2004). (Prawitt, Smith, & Wood, 2009) empirically proved that the internal audit function can improve the quality of financial reporting. They researched the relation between the quality of internal audit function and earnings management. Their results suggest that a high-quality internal audit is likely to deter managers from manipulating earnings or to detect such manipulations and ensure that they are corrected before financial statements are issued. (Ege, 2015) also provided evidence that internal audit quality is negatively associated with the likelihood of management misconduct, such as financial reporting fraud and misleading disclosure practices. Similarly, (Abbott, Daugherty, Parker, & Peters, 2016) showed in their research that quality of internal audit function positively impacts financial reporting quality. The impact of the quality of internal audit on the quality of financial reporting is largely indirect and is realized through internal control. Namely, the internal audit function improves the quality of financial reporting by eliminating or mitigating weaknesses in the internal control system.

Several studies empirically confirmed the existence of a positive impact of the quality of internal audit on the quality of internal control. (Fadzil, Haron, & Jantan, 2005) considered the impact of certain characteristics of the internal audit quality on the quality of individual components of internal control. The results of their research revealed that the performance of the audit work, professional expertise of internal auditors and their objectivity affect the control environment as a component of the internal control system while internal audit department management, performance of audit work, audit program and audit reporting significantly affect the quality of risk assessment as a component of the internal control system. The study also showed that performance of audit work and audit reporting significantly influence the quality of control activities as a component of the internal control system and that scope of internal audit work and performance of internal audit work significantly influence the quality of information and communication as a component of the internal control system. Lastly, the management of internal audit department, professional expertise of internal auditors and their objectivity significantly influence the quality of monitoring as a component of the internal control system.

(Mazza & Azzali, 2015) investigated the impact of internal audit quality on the severity and persistence of internal control weaknesses. They found that increased quality of internal audit was associated with reduced severity and persistence of internal control weaknesses, and thus higher internal control quality. In particular, they came to the conclusion that internal control weaknesses become less severe if the effectiveness of the audit cycle phases is improved. Also, weaknesses in internal control become less persistent through improving the quality of planning and determining the scope of internal audit, increasing the frequency of testing, improving the competencies of internal auditors and increasing their independence.

(Oussii & Taktak, 2018) also examined the association between the characteristics of the internal audit function and the quality of internal control. They found that the internal control quality is significantly and positively associated with the competence of internal auditors, internal audit quality control assurance level, application of procedures for monitoring the elimination of previously identified internal control problems and audit committee's involvement in reviewing the internal audit program and results. This research, as well as the two studies mentioned above, point out the importance of internal audit in ensuring the quality of internal control. Improving the competence of internal auditors and the performance of the company's internal audit function will contribute to strengthening internal control, and will therefore help managers to improve the quality of financial reporting of companies.

THE IMPACT OF OWNERSHIP STRUCTURE ON THE QUALITY OF INTERNAL CONTROL OVER FINANCIAL REPORTING SYSTEM

Previous literature indicates that the ownership structure is another important determinant of the quality of internal control over the financial reporting system (Chalmers, Hay, & Khlif, 2019; Chen & Keung, 2018; Bardhan, Lin, & Wu, 2015). The influence of concentration and type of ownership has been considered. It is assumed that concentrated ownership negatively affects the quality of internal control. Concentrated ownership refers to the case where majority of shares are held by few owners. In concentrated ownership companies, controlling owners usually hold positions in the top management and board of directors. Therefore, they are directly involved in the design and implementation of internal control over the financial reporting system. Their knowledge of the company together with their positions in the company enable them to monitor internal control better, detect weaknesses in internal control and improve internal control (Bardhan, Lin, & Wu, 2015). This could lead to the conclusion that concentrated ownership contributes to the improvement of the quality of internal control.

However, controlling owners can use their positions in the top management and the board of directors to pursue self-interests at the expense of minority owners. They seek to extract and take the company's resources for themselves by neglecting the interests of minority owners. To accomplish this, their interest is to establish weak internal control over the financial reporting system. Weak internal control leads to poorer quality of accounting records and less reliable financial statements. It can also increase the information asymmetry between majority and minority owners. Controlling owners often abuse their position to limit the flow of information to minority owners. Such situations affect the ability of minority owners to monitor the company's activities and react in case of opportunistic behaviour of the majority owners (Bardhan, Lin, & Wu, 2015). Thanks to weak internal control over the financial reporting system, controlling owners can conceal their opportunistic behaviour and discourage external intervention and monitoring.

Family-owned companies are the best example of companies with concentrated ownership in which controlling owners pursue personal interests at the expense of minority owners. A family-owned company is defined as a company where family members, either founders or descendants, hold positions in the top management and/or on the board of directors, or they are the company's largest owners. This type of company is characterized by fewer conflicts between owners and managers and more conflicts between majority and minority owners. The interests of managers and owners in family companies are better aligned because of concentrated ownership and active participation of owners in management.

(Bardhan, Lin, & Wu, 2015) found that family companies exhibit more material weaknesses in their internal control over the financial reporting system than non-family companies. Their further analysis showed that material weaknesses in internal control are more prevalent in family companies that have two types of owners, majority owners who are family members and minority owners who are not family members. They found no evidence to suggest that other types of family companies have more material weaknesses in internal control than non-family companies. Such results suggest that majority owners who are family members are abusing their positions in order to weaken internal control for the sake of pursuing personal interests at the expense of minority owners.

(Lin, Wang, Chiou, & Huang, 2014) analyzed the relationship between management ownership and internal control quality. They found that a higher level of management ownership is significantly associated with material weaknesses in internal control. Managers with a larger share in ownership have stronger control over the company. They have greater ability to pursue personal interests at the expense of other owners. As they have a great influence on internal control, they are likely to design and utilize poorer internal control and exploit material weaknesses in internal control in order to pursue personal interests. Despite their opportunistic behavior, it is difficult for minority owners to replace these managers.

(Chen & Keung, 2018) researched the influence of ownership by institutional investors on the quality of internal control. Institutional investors are professional investors who have advanced information gathering and processing skills. These investors have the necessary resources at their disposal to protect their investments. If they have a large share of ownership, institutional investors may have an interest in improving the business operations of the company. A large share of ownership allows them to monitor and discipline managers. They can put a pressure on the management to maintain effective internal control over the financial reporting system. However, the impact of institutional investors on the quality of internal control depends on the time horizon of their investments.

Institutional investors who invest in the long term have both the ability and the incentive to oversee managers and improve the business operations of the company. Due to the long-term investment horizon, they are interested in the stability of the company and the improvement of its long-term performance. This type of investor will not allow the management to manipulate financial statements for the sake of realizing short-term interests. They will encourage managers to invest in areas such as internal control that can contribute to the realization of long-term goals and results (Chen & Keung, 2018). This means that it can be expected that ownership by long-term institutional investors can have a positive impact on the quality of internal control over the financial reporting system.

On the other hand, institutional investors who invest in the short term have less reason to oversee management. They actively trade stocks in order to maximize short-term profits. In this regard, they are interested in the short-term results of the company and they do not usually question how the managers achieved those results. Managers of companies with dominant ownership by short-term institutional owners can adopt a short-term approach in decision making. They may decide to delay or forego investments in improving internal control in order to be able to manipulate the short-term results shown in the financial statements (Chen & Keung, 2018). Thus, companies with concentrated ownership by short-term institutional owners are more likely to have material weaknesses in their internal control over the financial reporting system than companies with concentrated ownership by long-term institutional owners. This has been confirmed in empirical research by (Chen & Keung, 2018) and (Tang & Xu, 2010).

THE IMPACT OF OTHER CHARACTERISTICS OF THE COMPANY ON THE QUALITY OF INTERNAL CONTROL OVER THE FINANCIAL REPORTING SYSTEM

The researchers have examined the impact of a number of company characteristics on the quality of internal control over the financial reporting system. The manner in which the quality of internal control over the financial reporting system is affected by the size of the company, the age of the company, its financial stability and complexity, growth rate and the fact that the company is in the process of restructuring has been considered.

There is a positive correlation between the size of the company and the quality of internal control over the financial reporting system. Large companies usually have numerous financial reporting procedures and more assets to be controlled. Therefore, their internal control systems are more complex than in smaller companies. However, this does not have a negative impact on the quality of internal control because large companies can invest significant resources in strong internal control. Large companies have a sufficient number of employees to ensure an adequate segregation of duties. They tend to spend large resources on internal audit, which can help create strong internal control. The design and implementation of internal control can cause large costs that are fixed in nature, but large companies can achieve economies of scale when developing and implementing an internal control system (Doyle, Ge, & McVay, 2007b). Smaller companies cannot invest large resources to establish strong internal control. They are less likely to have adequate staff and expertise to maintain this system. Therefore, smaller companies are more likely to have significant weaknesses in internal control. This has been empirically confirmed by (Doyle, Ge, & McVay, 2007b), (Ashbaugh-Skaife, Collins, & Kinney Jr, 2007) and (Ge & McVay, 2005).

The following factor that affects the quality of internal control is the age of the company. The more experience a company has, it is to be expected that it will have fewer weaknesses in internal control. Younger companies are likely to have fewer established control procedures, and their employees will have less experience in implementing those procedures. It follows that younger companies are likely to have lower quality internal control. Over the years, the company will eliminate deficiencies in its control procedures and thus improve the quality of internal control. The existence of a positive correlation between company age and the quality of internal control was empirically confirmed by (Doyle, Ge, & McVay, 2007b).

The quality of internal control is also affected by the financial condition of the company. Establishing and maintaining quality internal control requires managers to invest both time and financial resources. Companies facing financial difficulties will not be able to invest necessary time and money. Investing in internal control is not a priority for these companies. These companies can take actions such as downsizing, which can create gaps in their existing internal control. This will reduce the quality of internal control further. Therefore, it is to be expected that weaknesses in internal control will be more present in companies that achieve poor financial performance. In this regard, (Krishnan, 2005) found that the existence of a loss in financial statements is related to the existence of problems in internal control. (Ge & McVay, 2005) also confirmed that there is a negative association between the presence of weaknesses in internal control and the profitability of the company. Based on their own empirical research, (Doyle, Ge, & McVay, 2007b), (Ashbaugh-Skaife, Collins, & Kinney Jr, 2007) and (Ji, Lu, & Qu, 2015) obtained the same results.

Numerous studies have confirmed that the complexity of the company will have a negative impact on the quality of internal control (Doyle, Ge, & McVay, 2007b; Ashbaugh-Skaife, Collins, & Kinney Jr, 2007; Ge & McVay, 2005). The complexity of a company grows with the performance of complex transactions, doing business in various industries or doing business in international markets. These companies have a greater need for internal control, but it is believed that their complexity is the reason for the presence of weaknesses in internal control. The more complex the company's operations, the more difficult it is to establish adequate internal control. For example, companies with multiple geographic or business divisions face challenges in implementing internal control in divisions operating in different conditions and environments. The implementation of internal control in each division can be influenced by various factors, such as the local institutional and legal environment. In addition, companies with more divisions may face problems with control procedures related to the preparation of consolidated financial statements (Ashbaugh-Skaife, Collins, & Kinney Jr, 2007). Therefore, companies that have complex operations are more likely to have lower quality internal control than companies whose operations are less complex.

Another determinant of the quality of internal control is the rapid growth of the company. Companies that are experiencing rapid growth are more likely to have problems with the functioning of internal control because they are facing sudden changes in their organization and operation. Due to the increase in the volume of production and sales, the increase in the number of customers, entry into new markets or new industry, the existing control procedures become obsolete, and it takes some time for new ones to be established. New employees and new procedures are usually needed to align internal control with the growth of the company. (Doyle, Ge, & McVay, 2007b) as well as (Ashbaugh-Skaife, Collins, & Kinney Jr, 2007) empirically confirmed that companies that achieve rapid growth face weaknesses in internal control.

(Doyle, Ge, & McVay, 2007b) and (Ashbaugh-Skaife, Collins, & Kinney Jr, 2007) also found that the quality of internal control can be significantly reduced by the fact that the company is in the process of restructuring. Restructuring often leads to a change in the organizational structure, a reduction in the number of organizational units, the loss of experienced employees and the like. In such circumstances, some control procedures become redundant while others are missing. Reducing the number of employees can lead to problems with the segregation of duties and supervision. This reduces the quality of internal control. Internal control needs to be updated to suit the new organizational structure, but companies do not often have enough time during the restructuring process to devote to internal control. The negative impact of rapid growth and restructuring on the quality of internal control indicates that in order to establish quality internal control, it is necessary for the company to operate stably, without major changes and oscillations.

CONCLUSION

Effective internal control increases the quality of financial statements by reducing unintentional errors and providing better opportunities to deter and detect intentional manipulation of accounting information. In order for managers to be able to establish internal control that will ensure quality financial reporting, it is necessary to identify the determinants of the quality of internal control. The quality of internal control is determined by the characteristics of the board of directors, the audit committee and the internal audit as well as the company's ownership structure, its size, age, financial stability, complexity, growth rate and the fact that the company is in the process of restructuring. The board of directors and the audit committee which has a larger number of members, namely members who have accounting and financial knowledge, who are independent in relation to the management and who meet frequently will have a positive impact on the quality of internal control. The quality of internal control is affected by many aspects of internal audit quality such as: scope of internal audit, internal audit department management, efficiency of audit cycle phases, quality of planning and determining the scope of internal audit, increasing testing frequency, internal audit quality control assurance level, application of procedures for monitoring the elimination of previously identified internal control problems, audit committee's involvement in reviewing the internal audit program and results, professional expertise of internal auditors, their objectivity and independence and the like. Diversified ownership has a positive impact on the quality of internal control while concentrated ownership usually has a negative impact. The negative impact of concentrated ownership on the quality of internal control is especially pronounced in family companies that have two types of owners, majority owners who are family members and minority owners who are not family members, and in companies with concentrated ownership by short-term institutional investors. Concentrated ownership by long-term institutional investors can have a positive impact on the quality of internal control over the financial reporting system. The quality of internal control over the financial reporting system is positively influenced by the size of the company, its age and financial stability. On the other hand, the complexity of the company, its rapid growth and the fact that the company is in the process of restructuring have a negative impact on the quality of internal control.

LITERATURE

Abbott, L., Daugherty, B., Parker, S., & Peters, G. (2016). Internal audit quality and financial reporting quality: The joint importance of independence and competence. *Journal of Accounting Research, 54(1)*, 3-40.

Agrawal, A., & Chadha, S. (2005). Corporate governance and accounting scandals. *The Journal of Law and Economics, 48(2)*, 371-406.

Ashbaugh-Skaife, H., Collins, D., & Kinney Jr, W. (2007). The discovery and reporting of internal control deficiencies prior to SOX-mandated audits. *Journal of accounting and economics, 44(1-2)*, 166-192.

Ashbaugh-Skaife, H., Collins, D., Kinney Jr, W., & LaFond, R. (2008). The effect of SOX internal control deficiencies and their remediation on accrual quality. *The accounting review, 83(1)*, 217-250.

Bardhan, I., Lin, S., & Wu, S. (2015). The quality of internal control over financial reporting in family firms. *Accounting Horizons, 29(1)*, 41-60.

Campbell, S., Li, Y., Yu, J., & Zhang, Z. (2016). The Impact of occupational community on the quality of internal control. *Journal of Business Ethics, 139*, 271-285.

Chalmers, K., Hay, D., & Khlif, H. (2019). Internal control in accounting research: A review. *Journal of Accounting Literature, 42,*, 80-103.

Chen, G., & Keung, E. (2018). Corporate diversification, institutional investors and internal control quality. *Accounting & Finance, 58(3)*, 751-786.

Chen, Y., Knechel, W., Marisetty, V., Truong, C., & Veeraraghavan, M. (2017). Board independence and internal control weakness: Evidence from SOX 404 Disclosures. *Auditing: A Journal of Practice & Theory, 36 (2)*, 45–62.

Darrough, M., Huang, R., & Zur, E. (2018). Acquirer internal control weaknesses in the market for corporate control. *Contemporary Accounting Research, 35(1)*, 211-244.

Dellai, H., & Omri, M. (2016). Factors affecting the internal audit effectiveness in Tunisian organizations. *Research Journal of Finance and Accounting, 7(16)*, 208-211.

Dhaliwal, D., Hogan, R., & Wilkins, M. (2011). Internal control disclosures, monitoring, and the cost of debt. *The Accounting Review, 86(4)*, 45-69.

Donelson, D., Ege, M., & McInnis, J. (2017). Internal control weaknesses and financial reporting fraud. *Auditing: A Journal of Practice & Theory, 36(3)*, 45-69.

Doyle, J., Ge, W., & McVay, S. (2007a). Accruals quality and internal control over financial reporting. *The accounting review, 82(5)*, 1141-1170.

Doyle, J., Ge, W., & McVay, S. (2007b). Determinants of weaknesses in internal control over financial reporting. *Journal of accounting and Economics, 44(1-2)*, 193-223.

Ege, M. (2015). Does internal audit function quality deter management misconduct? *The Accounting Review, 90(2)*, 495-527.

Elbannan, M. (2009). Quality of internal control over financial reporting, corporate governance and credit ratings. *International Journal of Disclosure and Governance, 6(2)*, 127-149.

Fadzil, F., Haron, H., & Jantan, H. (2005). Internal auditing practices and internal control system. *Managerial Auditing Journal, 20(8)*, 844-866.

Ge, W., & McVay, S. (2005). The disclosure of material weaknesses in internal control after the Sarbanes-Oxley Act. *Accounting Horizons, 19(3)*, 137-158.

Goh, B. (2009). Audit committees, boards of directors, and remediation of material weaknesses in internal control. *Contemporary Accounting Research, 26*, 549-579.

Hoitash, U., Hoitash, R., & Bedard, J. (2009). Corporate governance and internal control over financial reporting: A comparison of regulatory regimes. *The Accounting Review, 84(3)*, 839-867.

Hu, G., Yuan, R., & Xiao, J. (2017). Can independent directors improve internal control quality in China? *The European Journal of Finance, 23(7-9)*, 626-647.

Ji, X., Lu, W., & Qu, W. (2015). Determinants and economic consequences of voluntary disclosure of internal control weaknesses in China. *Journal of Contemporary Accounting & Economics, 11(1)*, 1-17.

Khlif, H., & Samaha, K. (2016). Audit committee activity and internal control quality in Egypt: Does external auditor's size matter? *Managerial Auditing Journal, 31(3)*, 269-289.

Krishnan, J. (2005). Audit committee quality and internal control: An empirical analysis. *The Accounting Review, 80(2)*, 649-675.

Lai, S., Liu, C., & Chen, S. (2020). Internal control quality and investment efficiency. *Accounting Horizons, 34(2)*, 125-145.

Lin, Y., Wang, Y., Chiou, J., & Huang, H. (2014). CEO characteristics and internal control quality. *Corporate Governance: An International Review, 22*, 24-42.

Lisic, L., Neal, T., Zhang, I., & Zhang, Y. (2016). CEO power, internal control quality, and audit committee effectiveness in substance versus in form. *Contemporary Accounting Research, 33(3)*, 1199-1237.

Mazza, T., & Azzali, S. (2015). Effects of internal audit quality on the severity and persistence of control deficiencies. *International Journal of Auditing, 19(3)*, 148-165.

Michelon, G., Bozzolan, S., & Beretta, S. (2015). Board monitoring and internal control system disclosure in different regulatory environment. *Journal of Applied Accounting Research, 16(1)*, 138-164.

Ogneva, M., Subramanyam, K., & Raghunandan, K. (2007). Internal control weakness and cost of equity: Evidence from SOX Section 404 disclosures. *The Accounting Review, 82(5)*, 1255-1297.

Oussii, A., & Taktak, N. (2018). The impact of internal audit function characteristics on internal control quality. *Managerial Auditing Journal, 33(5)*, 450-469.

PCAOB. (2004). *An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements.* Washington: Public Company Accounting Oversight Board.

Prawitt, D., Smith, J., & Wood, D. (2009). Internal audit quality and earnings management. *The accounting review, 84(4)*, 1255-1280.

Tang, A., & Xu, L. (2010). Institutional ownership and internal control material weakness. *Quarterly Journal of Finance and Accounting, 49(2)*, 93–117.

Verschoor, C. (2002). Reflections on the audit committee's role. *Internal Auditor, 59*, 26-35.

Yazawa, K. (2015). The incentive factors for the (non-) disclosure of material weakness in internal control over financial reporting: Evidence from J-SOX mandated audits. *International Journal of Auditing, 19(2)*, 103-116.

Zhang, Y., Zhou, J., & Zhou, N. (2007). Audit committee quality, auditor independence, and internal control weaknesses. *Journal of Accounting and Public Policy, 26(3)*, 300-327.