Information Disclosure in Internal Control Based on the Motivation Selection Perspective

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Abstract. Since the release of a series of related laws and regulations of internal control in our country, the implementation and disclosure of it has improved step by step, but at present the situation is still not optimistic in the voluntary disclosure of listed companies' internal control information in general. Management is not willing to disclose the actual internal control information for their own benefits, which leads to the low quality of information disclosure in internal control in China's listed companies. This article mainly analyzes the reason why the management is reluctant to disclose internal control defects from the perspective of "motivation selection" and puts forward the suggestions on how to improve our country's internal control information disclosure of listed companies.

Introduction

Ever since the "enron event", a financial fraud scandal, the concerning departments in the United States launched the Sarbanes-Oxley Act jointly, the strictest one of which is article 404, requiring financial reports of listed companies to disclose internal control information. The aim, obviously, is to get the public aware of the company’s possible deception and ensure the reliability of financial reports. While in China, a series of shocking financial frauds also did happen. The well-known “Yingguangxia” event, “Lantian” event and so on reflect that there still exists a big problem in the internal control and its information disclosure in China's listed companies, requiring urgent improvement.

In June 2006, the Shenzhen stock exchange and the Shanghai stock exchange issued The Listed Company's Internal Control Guidelines in the first place, which aimed to promote and guide the listed companies to establish an integrated system of internal control, and raise the risk management levels. In 2010, the Ministry of Finance and five other ministries jointly issued The Application Guide of Enterprise Internal Control, Enterprise Internal Control Evaluation Guidelines and Enterprise Internal Control Audit Guidelines. The release of these laws and regulations shows that the Chinese government is making efforts to construct a relatively complete system of internal control and disclosure. Listed companies in China have entered an era which demands mandatory disclosure of internal control information.

Although laws and regulations about internal control have been issued, it’s still not optimistic in the voluntary disclosure of internal control evaluation reports in listed companies in our country on the whole. Therefore, efforts on improving the internal control information disclosure mechanism further(Cao Jianxin, 2010) should be made immediately. The specific disclosure information of listed companies is shown as table 1:

<table>
<thead>
<tr>
<th>Year</th>
<th>The total number of listed companies</th>
<th>Number of companies disclose internal control</th>
<th>Ratio of disclosure of internal control</th>
<th>Ratio of disclosure of internal control defects</th>
<th>Ratio of disclosure of major internal control defects</th>
<th>Ratio of none disclosure of internal control defects</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013</td>
<td>2489</td>
<td>2312</td>
<td>92.89%</td>
<td>18.51%</td>
<td>1.34%</td>
<td>81.49%</td>
</tr>
<tr>
<td>2012</td>
<td>2492</td>
<td>2244</td>
<td>90.05%</td>
<td>-</td>
<td>0.36%</td>
<td>-</td>
</tr>
</tbody>
</table>
Data source: The Ministry of Finance Accounting Department The analysis report on the implementation of enterprise internal control standard system of listed companies in our country

As is shown in table 1, though the listed companies disclosing internal control information occupied more than 90% in all of the listed companies, companies actually disclosing internal control defects take up only less than 20%. This result reflects the quality of internal control information disclosure is generally low and the disclosure still remains on the surface rather than its true defects(Yang Yufeng, 2010). At the same time, it reflects that there exists “motivation selection” on internal control information disclosure of listed companies in China.

The Theory of Information Disclosure in Internal Control

Review on Internal Control Information Disclosure Literature

Foreign scholars have begun studying the internal control information disclosure since the early 20th century, and theoretic work became much better after the Sarbanes-Oxley Act. Bryan(2005) found in his research that companies who dare to disclose significant defects tend to be those of small scale, poor performance and high financial risk.

Domestic researches have also made many achievements in recent years. Chen Xiaojian(2010) found that companies with good profitability are more willing to disclose internal control information, while those with high ownership concentration are much less likely to do the same in internal control information disclosure. Shao Menglu(2012) explained the reason why the management is not willing to disclose the internal control defects from the “motivation selection” perspective. They found out that the dominant cost, recessive cost of the incentive mechanism and the disclosure of internal control defects is a driving force for management to conceal internal control defects, for imperfect internal and external governance environment make management easier to speculate for their own benefits.

Predecessors' research results may explain why financial fraud appeared again and again, why the listed companies are reluctant to disclose their internal control defects and why the disclosure of internal control information is not reliable.

The Importance of Internal Control Information Disclosure

Internal control have been paid great attention to ever since it was proposed. Up to now, the internal control has moved to stage five, a risk management integration framework stage during which risks are oriented. At this time, internal control pays much more attention to beforehand and in-process control and the elements of internal control have developed from the early three elements to five, then to eight. Although the relevant laws and regulations have already made a definition of internal control information disclosure, this essay defines the internal control information disclosure mainly from two aspects: one is mandatory, which requires listed companies to disclose internal control information according to laws and regulations; the other is the form of disclosure, which includes the internal control self-assessment report and internal control verification report issued by the CPAs. The importance including:

First, internal control information disclosure helps external information users to understand the reliability of financial reports enterprises provided, which enhances the external supervision to a certain extent and reduces the occurrence of the fraud;

Second, internal control information disclosure will help the management show owners entrusted operating results;

Third, internal control information disclosure is helpful to raise internal control consciousness of management;

Fourth, internal control information disclosure can provide information expect the financial statement to help the users make deciding analysis.
The Motivation of Information Disclosure in Internal Control

Motivation of Internal Control Information Disclosure of Management

According to the rational economic man principle, owners and managers pursue the maximum benefit at the same time. At this point, management may take the advantage of their information to seek for personal interest, thus causing moral hazard. This may explain why management wants a window dressing in return for the trust and affirmation of stockholders. Financial scandals which happened in many well-known companies can lead to some thinking: information disclosure which should have been as external supervision, may be whitewashed and disclosed selectively by executives as a way to seek for personal interest. Self-consciousness of the "rational" management to disclose internal control defects is not just enough, and there exist “motivation selection” problems in the internal control information disclosure.

Information disclosure has certain economic cost. Factors the management has to consider when disclosing the internal control defects are as following:

It costs much to disclose internal control defects. The cost to disclose internal control information can be divided into two parts: one is direct cost, such as the cost of construction, maintenance, execution. If the company is on a small scale, it may choose not to disclose internal control information because direct costs alone may be unbearable for the company. The other is the hidden costs, or called the opportunity cost. If the management discloses internal control defects, possible financial report users may doubt the authenticity and reliability of financial reports issued by management before.

Disclosure of internal control defects leads to the suppression of "tunneling". Well-corporate governance structure can inhibit the "tunneling" of shareholders and the internal control system is an important aspect of corporate governance. That is to say, effective operation of internal control system can achieve the balance of rights to some extent, thus reducing ethical risks brought by the asymmetry of information and the adverse consequences brought by reverse selection.

Disclosure of internal control defects affects job promotions of management. On one hand, if the management whitewashes internal control defects, they will not be criticized by shareholders because of organizational slack and poor management. On the other hand, executives may build up investors’ confidence in the enterprise through window dressing to push the share price up. In conclusion, managers have an incentive to disclose good news frequently to whitewash the company performance for retention.

Although there exist all sorts of conflicts between the disclosure of internal control defects and management interest, it does not mean that the disclosure of internal control defects is nothing. The benefits of internal control information disclosure mainly embody in: first, it can avoid violations cost effectively; second, it can build up good-looking social image; third, it can eliminate the misunderstanding of investors and other stakeholders; fourth, it can create a favorable market environment for the listed company, etc.

Internal control information disclosure has to observe principle of cost effectiveness, so when the management of listed companies disclose internal control information of defects, they will make a trade-off between the costs and benefits, as a result, the "motivation" occur. In addition, it can be derived from the signal transmission theory that a listed company with higher quality or intention to window dress will take the initiative to provide the internal control information to stakeholders to obtain the trust of them. In turn, listed companies are not voluntary to disclose internal control defects. This conclusion can also be made from data released by the ministry of finance accounting department that the rate of voluntary disclosure of internal control defects is only 18.51%.

Authenticity of Internal Control Information Disclosure Based on the "Motivation Selection"

Internal control is an interior part of the management function and a process to achieve the aim of control. Internal control is inherent in the management, so it’s the responsibility of the management to establish and maintain the internal control though its formulation has been affected by external
environment. Internal control information disclosure is a measure to inspect whether the company's management organization and implementation of the internal control are effective. Management should assess themselves for the comprehensiveness, importance, rationality and effectiveness of the internal control in their companies in accordance with the established evaluation criteria, and passed to the external information users in the form of report. The purpose of disclosure is to make the stakeholders understand the status of the enterprise's internal control and to provide additional information for financial report. However, how about the authenticity of internal control information disclosure by management?

As internal control information disclosure is the work of self-assessment by the management, they may not completely deny their own work and efforts according to the principle of self-interest, so they may decorate and understate the real situation of internal control information. In addition, listed companies of poor quality in internal control are more reluctant to disclose real internal control information, or they may adopt a policy of vagueness to muddle through. The authenticity of internal control information under the "motivation selection" cannot be trusted completely and disclosure of internal control information does not completely reveal the defects of internal control. Internal control information disclosed by management under the "motivation selection" is shown in figure 1:

![Figure 1. Internal control information disclosed by management under the “motivation selection”.

The Relationship Between Management Decision and Internal Control Information Disclosure

Different listed companies have different motivations on internal control information disclosure. In general, the higher the quality of internal control of the listed companies is, the more likely they are to disclose internal control information truthfully according to the signal transmission theory, for it will do good to financing at a low cost. However, in another way, if the listed company is of low quality of internal control itself, disclosure of the authentic internal control information will make investors "vote with their feet", or simply step back. What kind of motivation is for management to disclose internal control information should take management decisions into account.

Internal control is a continuous process driven by people, in which internal staff exchange information with external personnel and external environment continuously. According to the theory of "rational man" and "social man", the self-assessment report of internal control is already processed by management and internal control information disclosure is the result of cost-benefit balance based on the "motivation selection". Figure 2 shows logic analysis framework of management
decision-making, internal control and internal control disclosure, and it explains why the external stakeholders are blocked outside the whole system:

So, internal control information disclosure is affected when there exists a "motivation selection" in management and this effect is a continuous process.

**Suggestions to Improve the Internal Control Information Disclosure of Listed Companies**

To sum up, there still exists big problems in the authenticity in the disclosure of internal control information due to "motivation selection" of management. In order to implement the provisions of laws and regulations related to internal control information disclosure, this essay puts forward suggestions as the following:

**Strengthen the Supervision by External Supervision Department**

The concept of internal control regulation should be centered on information disclosure. As mentioned in the introduction, the internal control information disclosure in our country has entered an era of mandatory disclosure, so regulators should correctly guide the listed companies to disclose internal control information and strictly regulate the content and disclosure quality of the evaluation report and audit report on internal control of the listed company. Regulators should also organize professionals to conduct regular inspection of listed companies and punish those who are perfunctory, attaching greater importance to forms rather than essence, and disclose false information or conceal important internal control defects severely, with no mercy and heavy penalties. Responsibility of management in the process of internal control information disclosure should also be cleared in order to make it cost too high for the listed companies to violate regulations.

**Strengthen Professional Ethics Education of Enterprise Management**

Cynthia Cooper used to be the vice president of internal audit department in WorldCom and the latter MCI. As a witnesses of the most notorious company fraud in Wall Street history, she bravely stood up and pointed out the major defects of internal control, thus crowning time magazine in 2002 and becoming the pronoun of integrity and bravery. An important factor in internal control environment is the managers' values and ethics. If the compulsory behavior rules made by organizations emphasize the integrity and good moral values, it will be easier to implement internal control process and there would be almost no chance of a major defects. Or even if the internal control defect does occur, management and leadership subordinates will explicitly point out the existence of defects, which can guarantee the authenticity and reliability of the internal control information to a certain extent.

**Quantify Internal Control Defect Standards**

It is pointed out that the enterprise shall divide layers of different defect degree according to the severity of the realization of overall control objectives affected by internal control defects in the
existing laws and regulations, and divide the internal control defects into general defects, important
defects and major defects (also known as substantive holes). But laws and regulations require
companies to evaluate the defects belonging to what kind of degree by themselves. There is no doubt
that the subjectivity of self assessment connives in the self-serving act of the management to a certain
extent, providing a window for their "motivation selection" and the convenience to whitewash the
internal control defects. In reaction to the phenomenon, the recognition of the wrong cons matters
"importance" by CPAs in the financial statements audit can be consulted and it can be determined
from two aspects--the amount and severity of nature of related matters.

**Perfect Governance Structure of Listed Companies**

Well-rounded corporate governance structure can create a good internal environment for internal
control information disclosure. A good corporate governance structure can make a good internal
control system operation and reduce the chances of defects during the operation of internal control.
Internal control audit department in the company must be referred to as the corporate governance
structure. At present, internal audit department in many listed companies can be evaded because it
doesn’t have the function of supervision, which still remains to be resolved. Meanwhile, interest
between big shareholders and smaller ones should also be coordinated to improve the corporate
governance structure, and the supervision of the board of directors, board of supervisors, audit
committee should be taken full advantage of to reduce the damage to the interest of small
shareholders by major ones in listed companies through the "tunneling”.

**Conclusion**

Laws and regulations of internal control gradually formed a system and improved day by day, but the
phenomenon is widespread in our country that internal control information disclosed ultimately is a
result of “motivation selection” made by management. This thesis recommends that if management
can be guided correctly and punished appropriately, and relevant laws and regulations can be
quantified, the manipulation of internal control information disclosure by management can be then
minimized to improve the quality of internal control information disclosure.

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