

COSO-Based Internal Control and Comprehensive Enterprise Risk Management: Institutional Background and Research Evidence from China

Subjects: **Others**

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China's internal control framework follows the Committee of Sponsoring Organizations (COSO) framework, emphasizing enterprise risk management and encompassing financial reporting, operations, compliance, and strategies. The authors review research that uses the COSO-based Internal Control Index to assess internal control quality among all publicly listed firms in China. Unlike the binary classification of internal control weaknesses under the Sarbanes-Oxley Act Section 404, this continuous index captures more nuanced variations in internal control effectiveness and provides two key advantages over traditional assessment of internal control over financial reporting (ICFR). First, while financial reporting can enhance a firm's monitoring and decision-support systems, the underlying information is determined by operations. Thus, internal control over operations has a greater impact on a firm's performance than ICFR. While U.S.-based research argues that the effects of ICFR extend to operations, the COSO-based index includes operational controls, allowing for a more direct study of internal control effects. Second, many U.S. corporations fail to report internal control weaknesses, particularly during misstatement years. In contrast, the COSO-based index, compiled by independent scholars, avoids managerial incentives to withhold negative internal control information. Covering institutional background and research evidence from China, the authors survey a wide range of internal control studies related to various aspects of enterprise risk management, such as earnings quality, crash risk, stock liquidity, resource extraction, cash holdings, mergers and acquisitions, corporate innovation, receivable management, operational efficiency, tax avoidance, and diversification strategy.

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Although the Securities and Exchange Commission (SEC) recommends the Committee of Sponsoring Organizations (COSO)'s internal control framework and some U.S. firms adopt it voluntarily, U.S. regulations focus narrowly on internal control over financial reporting (ICFR). This inconsistency stemmed from a swift response to public outrage over accounting scandals like Enron and WorldCom. Consequently, the Sarbanes-Oxley Act (SOX) Section 404 mandates ICFR to restore stakeholder confidence in financial reporting. In contrast, China not only adopts COSO's internal control framework but also integrates it with COSO's risk management framework. This approach regulates both financial and non-financial reporting issues, such as compliance, operations, asset safety, and strategy, enhancing the operational and management capabilities of enterprises, especially state-owned ones operating overseas.

The authors survey existing literature that employs the COSO-based Internal Control Index, developed to evaluate internal control quality among all publicly listed firms in China [1]. Compared to the U.S., China's framework and regulations follow COSO's comprehensive model and emphasize enterprise risk management. This comparative analysis offers valuable insights into two distinctive paradigms of internal control regulations. Countries such as the U.S., the U.K., Canada, and Japan typically adopt a narrow approach, focusing primarily on ICFR. In contrast, countries like China, Germany, Australia, and members of the European Union implement a broader framework that encompasses both financial and non-financial reporting [2]. By examining the practical implications of these two different approaches, this analysis contributes to a more comprehensive understanding of the relative effectiveness of internal control systems and their suitability for specific nations.

The current entry provides a comprehensive overview of China's COSO-based internal control practices and related empirical studies. First, the authors introduce China's internal control framework and regulations, highlighting their evolution and differences from those in the U.S. Second, the authors present the Internal Control Index built on China's COSO-based framework and regulations, exploring its advantages. Third, the authors review empirical studies that utilize this index to examine the risk management role of internal control in various operational and management activities, such as compliance, asset safeguarding, diversification strategy, cash holding, mergers and acquisitions, innovation, accounts receivable management, exchange rate risk management, tax avoidance, and operational efficiency. Finally, the authors identify future opportunities in China's internal control research based on the above analysis.

References

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