

DEVELOPING INTERNAL CONTROL SYSTEMS, CORPORATE FORMS, AND THE RELIABILITY OF FINANCIAL REPORTS

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ABSTRACT. The author discusses some of the main positions in the debates about internal control systems, corporate forms, and the reliability of financial reports. Iwasaki looks at the legal framework regulating the corporate forms of the Russian JSCs as well as its significance in the context of organizational strategy. Himeno looks at the roles of information security and associated loopholes as it relates to the development of overall IT control systems. Kvassov makes an attempt to work out an approach to the development of information systems (IS) that takes into account a manager's personality type and preferences.

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Iwasaki examines a variety of factors as to why Russian stock companies select to become closed JSCs, and deal with the relationship between the corporate forms and internal organizational structures, as well as with the impact of these institutional couplings on organizational behavior, including corporate performance. Iwasaki looks at the legal framework regulating the corporate forms of the Russian JSCs as well as its significance in the context of organizational strategy, examines the determinants of organizational choices between open and closed JSCs, focuses on the institutional complementarity of corporate forms and internal organizational structures, and analyzes the relationship between institutional equilibrium of a corporate organization and organizational behavior. “Unlike open JSCs,

whose shares issued at the time of formation may be allocated to their promoters and to the general public (i.e., establishment with outside offering), closed JSCs are required to issue their shares only to their promoters and the other investors specified in advance. Even after incorporation, closed JSCs are not allowed to offer new shares to the general public, although they may issue corporate bonds other than convertible bonds on the securities market as a means of raising funds from outside sources.”¹ Iwasaki argues that there are no differences in the applicable tax provisions between open and closed JSCs: both of these corporate forms are regulated by the principle of equal taxation with respect to corporate ownership, investors, and capital sources. A great number of corporate executives see an inseparable relationship between their organizational choice and business activities regardless of the difference in the corporate form of their companies. The growing trend toward a market economy and its integration into the global economy are forcing domestic firms to tackle the issue of optimal adaptation to ever-changing business environments. “Strict restrictions imposed on a closed JSC on the transfer of its shares significantly decrease the possibility of a change in its internal control or ownership that may be made due to an ‘exit’ from the company of its shares sold, tender offer, proxy fight, and bankruptcy, posing a serious impediment to the reshuffling of a management body that has failed to come up with effective corporate discipline and to achieve the expected performance.”² Iwasaki says that the organizational advantages of a closed JSC as an “institutional defense barrier” become trivial for group companies. The presence of outside shareholders diminishes the probability that an investment-target firm will become a closed JSC. Russian managers place more importance on maintaining effective control of their company than on obtaining capital gains by having stock in their companies. “Choosing which corporate form to take has an important strategic meaning for a JSC with regard to defining its organizational openness and balancing the power between its managers and shareholders; however, this is not the only step required. Its objective is fulfilled when the company has finalized its internal organizational structure by, for example, drawing up a corporate charter and electing the corporate bodies required by law.”³

Compensation plans that pay bonuses on an accounting outcome are positively correlated with income-increasing accounting choices in periods when the accounting income falls within certain explicit or

implicit earnings-related bounds.⁴ For negative total news firms, warning investors of impending bad news appears to have a more pronounced negative effect on stock price compared to not warning.⁵ Liu and Thomas include analysts' forecast revisions in their returns/earnings regression equation to proxy for the market's change in expectations of future earnings (this variable is highly significant in explaining contemporaneous returns).⁶

Himeno looks at the roles of information security and associated loopholes as it relates to the development of overall IT control systems. Investments made by companies subject to auditing have become excessive, leading to a need for reviewing the best way to implement the SOX Act. A major advantage of third-party certification is that it facilitates company understanding of the critical features in the development of an overall IT control system. "The following systems can provide references for ways of developing internal control systems. They are ISO9001 (quality management system), which gained considerable attention in the 1990s as a modern service management quality control method, ISO27001 (conformity assessment scheme for information security management systems (ISMS)), for which third-party certification was started by JIPDEC in 2001, and ISO20001 (conformity assessment scheme for IT service management systems (ITSMS)), for which third-party certification is scheduled to start in April 2007."⁷ Himeno claims that business process level internal controls are achieved through three control methods: manual control, the use of IT and IT-based control. The participation of management executives is essential to develop a company-wide internal control. The objective of information security is to assure confidentiality, integrity and availability (the development of an internal control system should emphasize CIA). "To ensure the integrity of information, it is essential to prevent the tampering of data, which requires the establishment of mechanisms whereby only persons with the required authority can access the data. To ensure such integrity of information, there is a need for distinguishing levels of authority and an access management technology that supports such distinction. [...] It is important to properly implement information security management by clarifying individuals' authorities and by accurately reflecting any changes in the authorities designated in the system."⁸ According to Himeno, from the perspective of information security, there are loopholes in internal controls in the IT field (such as potential risk of the disclosure of data through

employee actions). When considering internal controls from the perspective of information security, it is important to ensure integrity such as by providing a function to support the distinction of persons with the required authority. Regarding information security measures, many companies have perfect technical measures in place, but their employees have not been fully educated in the fundamentals of information security. "Because only management is in a position where it can review company-wide rules, facilitate a reform in the attitudes of employees and all related persons, incorporate such rules into all business activities and establish a company-wide system, management executives must be very active in educating company employees about information security and preventing the disclosure of personal and confidential information."⁹

Kvassov makes an attempt to work out an approach to the development of information systems (IS) that takes into account a manager's personality type and preferences. Considering productivity only from an investment perspective brings a good understanding of economic trends, but few insights into how IT affects the nature of managerial work. Middle managers perceive IT as a significant leverage of their productivity, while senior managers estimate the impact of IT on their work rather pessimistically. "The IT support of ill-structured tasks (tasks that constitute a significant part of senior managers' work) has yet to be improved. While the work of middle managers is greatly influenced by organizational processes, the work of senior managers is influenced by such a factor as their personality. Personal preferences are neglected in current practice of IS development – a fact that weakens the positive impact of IT on the productivity of managers."¹⁰

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