

DISCLOSURES ON CONTROL OVER FINANCIAL REPORTING: THE REPORTING PRACTICE OF BANKS LISTED ON THE WARSAW STOCK EXCHANGE

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Abstract

The purpose of this paper is to identify the effects of the implementation of selected regulations on corporate governance in the reporting practice of banks listed on the Warsaw Stock Exchange. The survey examined the disclosures concerning the main features of the internal control and risk management systems in relation to financial reporting in banks. Research studies on disclosures related to control over financial reporting have not yet been conducted. The paper uses a research method involving the analysis of annual reports disclosed by banks. The method of induction was used in the process of inference. The results of the study indicate that in the practice of reporting of banks listed on the Warsaw Stock Exchange in 2011, there was no uniform reporting form in terms of the presentation of information on internal control or risk management systems in relation to financial reporting. The disclosures were different both in terms of level of detail and content. In some banks disclosures were drawn at a high level of generality.

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INTRODUCTION

The beginning of the twenty-first century was a kind of turning point in the functioning of the accounting information system. Financial scandals associated with Enron and WorldCom in the United States and the ensuing scandals in the European Union shook the world and exposed the weakness of the reporting process, both financial and non-financial. As noted by T. Clarke (*US Crisis of Confidence, 2002, p. 24*) ‘the collapse of Enron has disclosed that every component of the infrastructure of US capitalism was dysfunctional. Companies’ accounts were misleading, their auditors conniving, their lawyers conspiring, the ratings agencies asleep and the regulators inadequate.’

Financial scandals have become a driving force behind legislative actions both in the United States and Europe. New regulations also involved disclosures in the field of corporate governance made by listed companies. Legislative order in this field seems to be particularly valuable because disclosures in the field of corporate governance are an important tool for eliminating information asymmetry. As shown by the results of the research the level of disclosure in the field of corporate governance is positively correlated with the degree of separation of ownership from management and the level of uncertainty about the profits presented in annual reports (Bauwhede & Willekens, 2008, p. 112).

The purpose of this paper is to identify the effects of the implementation of selected regulations on corporate governance in the reporting practice of banks listed on the Warsaw Stock Exchange. The survey examined disclosures on the main features of internal control and risk management systems in relation to financial reporting (in this paper the Author also uses the abbreviated name ‘control over financial reporting’) in banks.

As noted by M. Marcinkowska (2013, p. 53) banks are unique capital market participants due to their activity and a greater number of stakeholders involved in their operation than in the case of other public companies. In addition, the problem of information asymmetry in banks is more exposed than in non-financial entities.

It should be emphasized that the studies conducted so far have focused on the functioning of internal control and risk management in enterprises (e.g. Hoitash, Hoitash & Bedard, 2009; Tipuric, Tusek & Filipovic, 2009; IFAC, 2011; PricewaterhouseCoopers, 2009; 2013; Banaszekiewicz, Bem, Bryl, Górnik, Kozera, Leski, Łapiński, Wietrzyk & Witalis, 2003).

Research studies on disclosures related to control over financial reporting, however, have not yet been conducted.

This paper uses a research method involving the analysis of annual reports disclosed by banks. An induction method was used in the process of reasoning.

CHANGES IN REGULATIONS IN THE UNITED STATES AND THE EUROPEAN UNION AS A CONSEQUENCE OF THE FINANCIAL SCANDALS OF THE EARLY TWENTY-FIRST CENTURY

The issue of changes in regulations following the financial scandals of the early twenty-first century was investigated in a number of scientific publications in the world (Clarke, 2005; Horn, 2012; Bauwhede & Willekens, 2008; Hoitash et al., 2009). From the perspective of this publication changes related to corporate governance are particularly relevant.

It should be noted that falsifying financial statements in order to hide the difficult financial situation was the key abuse at Enron. The bankruptcy of Enron contributed to the modernization of regulations which increase the reliability of the information disclosed in financial statements. The Sarbanes-Oxley Act enacted in 2002 in the United States is an example of such regulations. One of the key provisions of the Act related to disclosures on internal controls over the accounting system (Clarke, 2004, p. 159). The provisions of the Sarbanes-Oxley Act require companies to draw up an internal control report. The institution of internal control is appointed by the managers in order to assure investors that the disclosed financial data are reliable. An internal control report must confirm the fact that management is responsible for establishing and maintaining adequate internal control structures. Furthermore, the effectiveness of internal control over financial reporting data prepared by management must be assessed by outside auditors.

The European legislative response to the Sarbanes-Oxley Act was a report prepared under the direction of J. Winter (2002) presented on 4 November 2002, ‘A modern regulatory framework for company law in Europe’. In response to the Enron case, the European Commission and the ECOFIN Council agreed that a team led by Winter dealt with the matter of good practice in corporate governance and auditing. It was also suggested that the annual report on corporate governance contained at least information on the risk management system

implemented in the company, a description of the key strategies and a description of the company, as well as information on the various types of risk associated with this activity. If the company does not have such a system it should be disclosed (Winter, 2002, p. 47). As noted by L. Horn (2012, p. 96) of the Winter team, the recommendations have a fundamental impact on further initiatives in the field of company law and corporate governance. Suggestions formulated in the Winter report are reflected in ‘Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward’ (hereinafter - ‘A Plan’) developed in May 2003. ‘A Plan’ was, inter alia, to help stimulate the development of international regulations on company law and corporate governance. This plan was understood as an opportunity for the EU to be a catalyst for a global change for good and reasonable principles of corporate governance. ‘A Plan’ emphasizes that public companies should be required to include in their annual reports a descriptive statement covering the key elements on the structure and practice of corporate governance. The report should include, inter alia, information on the existence of a risk management system and the nature of this system. The provisions of ‘A Plan’ are reflected, inter alia, in Directive 2006/46/EC of the European Parliament and of the Council of 14 June 2006 *amending Directive 78/660/EEC on the annual accounts of certain types of companies, 83/349/EEC on consolidated financial accounts, 86/635/EEC on the annual and consolidated financial statements of banks and other financial institutions and 91/674/EEC on the annual and consolidated financial statements of insurance undertakings*, and thus became a part of EU law. In accordance with paragraph 10 of the Directive, companies whose securities are admitted to trading on a regulated market and whose head office is located in the Community, should be obliged to disclose an annual statement on corporate governance being a specific and clearly identifiable part of the annual statement. This statement should provide shareholders with easily accessible, relevant information about the actual practices of corporate governance of the company, including a description of the main features of any existing systems of risk management and internal controls in relation to the financial reporting process.

The provisions of the Directive have been implemented into Polish law under the Regulation of the Minister of Finance of 19 February 2009 *on Current and Periodic Information Provided by Issuers*

of Securities and Conditions for Recognizing as Equivalent Information Required by the Law of a Non-Member State. Pursuant to the provisions of this Regulation the activity reports (management reports) of all issuers should include – constituting a separate part of the report – a statement of corporate governance, which includes, inter alia, information on the description of the main characteristics of the issuer’s internal control and risk management systems in relation to the process of the preparation of financial statements and consolidated financial statements.

It should be noted that the control procedures on reporting are included, inter alia, in an integrated COSO internal control model. This model includes the following components: risk assessment, internal control environment, control activities, information, communication, and monitoring (IAASB, 2006).

Given the wide-ranging legislative actions and their reasons, it seems that the disclosure on the main features of the internal control and risk management systems will increase the reliability of financial reporting.

DISCLOSURE ON CONTROL OVER FINANCIAL REPORTING IN THE STRUCTURE OF ANNUAL REPORTS

The annual report is the primary tool by which a company transfers information to stakeholders about its financial condition, changes in financial condition, and performance. The structure of the annual report is largely determined by the regulations in force in the country. The financial statements seem to be particularly important, they are a kind of window through which stakeholders can ‘look’ into the enterprise (Gad & Walińska, 2012, p. 109). In turn, non-financial information accompanying the financial statements allows better use of the financial reporting potential.

Since 2009, public companies in Poland have been obliged to disclose information concerning the main characteristics of internal control and risk management systems in relation to the process of financial reporting. These disclosures are part of the statement on corporate governance, which in turn is a component of the annual report. The main task of these disclosures is to provide information on the main principles, tools, internal controls and risk management mechanisms within the accounting information system. These disclosures show whether the company has implemented a control system over financial reporting, and if so, how it functions.

According to the definition prepared by IFAC (2011, p. 9), an internal control system is ‘an integrated part of an organization’s governance system and risk management, which is understood, effected, and actively monitored by the organization’s governing body, management, and other personnel, to take advantage of opportunities and to counter the threats, in line with risk management strategy and policies on internal control set by the governing body to achieve an organization’s objectives.’ Risk management is defined in turn as ‘coordinated activities to direct and control an organization with regard to risk’ (ISO 31000:2009).

The key question seems to be whether the obligation to prepare the disclosures on the key features of the internal control and risk management systems in regard to financial reporting will affect its credibility in the long term. A lot depends on how the disclosures will be made by the companies. If they contain generalities transferred from other parts of the annual report then they will not bring additional value to the reporting process. Therefore, empirical research in this area seems significant.

It should be emphasized that the Polish regulations do not contain guidelines as to what information should be included in the disclosures on the main features of the internal control and risk management systems in relation to the financial reporting process.

DISCLOSURE ON CONTROL OVER FINANCIAL REPORTING IN BANKS - RESEARCH RESULTS

The objective of the study was to determine the information content of disclosures on internal control and risk management systems in relation to the financial reporting process in banks.

The survey examined the annual reports of 16 banks operating on the Warsaw Stock Exchange (Alior Bank, Bank Gospodarki Żywnościowej, BNP Paribas Bank Polska, Bank Ochrony Środowiska, Bank BPH, BRE Bank, Bank Zachodni WBK, Getin Noble Bank, Getin Holding, Bank Handlowy w Warszawie, ING Bank Śląski, Bank Millennium, Nova Kreditna Banka Maribor D.D., Nordea Bank Polska, Bank Polska Kasa Opieki, Powszechna Kasa Oszczędności Bank Polski).

From the perspective of this paper it seems important that banks, as part of their management system, have at least (Marcinkowska, 2013, p. 263): a risk

management system and an internal control system.

The annual reports for the year 2011 have been qualified for the study. It was assumed that as regulations regarding the obligation to disclose information on control over financial reporting had been in force for two years, the practice of reporting would have developed a certain form of presentation of the above information.

The following research questions related to disclosures on internal control and risk management in relation to financial reporting were formulated:

- 1) is it possible to identify specific groups of information presented by the surveyed banks in disclosures about control over financial reporting?
- 2) what is the nature of the information concerning control over financial reporting presented by banks (detailed information - aggregated information)?
- 3) which information relating to control over financial reporting banks is most often disclosed?

The survey results show that the surveyed entities presented information on control over financial reporting within the 10 main groups of disclosures:

- 1) characteristics of internal control and risk management systems
- 2) IT tools
- 3) risk
- 4) managerial accounting
- 5) preparation of financial statements
- 6) regulations
- 7) external audit
- 8) audit committee
- 9) security and data protection
- 10) internal audit

We can distinguish groups of disclosures in which banks presented detailed information (e.g., ‘Characteristics of internal control and risk management systems’) and groups of information, which included general information (e.g., ‘IT tools’).

In the ‘Characteristics of internal control and risk management systems’ disclosure group, most of the banks presented benefits associated with the operation of the system (75% of the surveyed units). Within this group of disclosures the banks also presented components of the control system and forms of control (Tab. 1). In this group of disclosures the banks presented most of the detailed items.

Table 1: Detailed disclosures within the - ‘Characteristics of internal control and risk management systems’ disclosure group

Disclosure group	Detailed items	%*
Characteristics of internal control and risk management systems	The definition of internal control and risk management systems in relation to the financial reporting process	6.25 %
	The benefits associated with the functioning of the system (principles of an effective system)	75.00 %
	The unit (s) responsible for the operation of the control system (e.g. management board, chief accountant)	18.75 %
	The tasks of the individual units operating within the company related to the functioning of the system	6.25 %
	Information on the procedures associated with the functioning of the system	6.25 %
	The components of the internal control and risk management systems. The concept of the three lines regarding the internal control and risk management systems	56.25 %
	Forms of control operating within the system (functional control, institutional control, self-control of correctness of own work)	56.25 %
	Tasks of functional control (checking whether the processes are running properly, analysing whether the procedures are performed by the personnel, if there is conflict of interest, monitoring financial reporting, checking compliance with the rules)	6.25 %

Source: Author’s own compilation
*Percentage of companies presenting an item.

Table 2: Detailed disclosure within the ‘IT tools’ group

Disclosure group	Detailed items	%*
IT Tools	Information on the use of IT tools for the (e.g. integrated IT system)	37.5 %

Source: Author’s own compilation
*Percentage of companies presenting an item.

Table 3: Specific disclosures within the ‘Risk’ group

Disclosure group	Detailed items	%*
Risk	Units responsible for risk management associated with the preparation of financial statements	12.5 %
	Types of risks associated with the preparation of financial statements	12.5 %
	The Risk management tools	25.0 %
	Information on the implementation of the risk management process in relation to the financial reporting process (identification and assessment of risk areas and identifying the actions necessary to reduce or eliminate risk, separating the units responsible for different types of transactions on the market (possibly exposed to various risks))	31.25 %
	Information on risk management policy. The use of internal procedures for managing risk.	6.25 %

Source: Author’s own compilation
*Percentage of companies presenting an item.

In the ‘IT tools’ disclosure group the banks typically indicated only that they use IT tools in the system of control over financial reporting (Tab. 2). In the ‘Risk’ disclosure group the banks presented i.a. information on the types of risk, risk management tools, and units responsible for risk management (Tab. 3). Least often banks presented information on the risk management policy. In the ‘Managerial accounting’ disclosure group the examined banks merely indicated that internal

(managerial) reporting operates in the bank for monitoring the risk level (Tab. 4). Information on units responsible for preparing the financial statements were presented in the ‘Preparation of financial statements’ disclosure group. Fifty percent of the banks revealed this information. In this disclosure group the banks also presented information on the financial reporting process (Tab. 5).

Tabela 4: Disclosures on non-financial risk exposures

Disclosure group	Detailed items	%*
IT Tools	Information on the use of IT tools for the (e.g. integrated IT system)	37.5 %

Source: Author’s own compilation

*Percentage of companies presenting an item.

Tabela 5: Detailed disclosures within the ‘Preparation of financial statements’ group

Disclosure group	Detailed items	%*
Preparation of financial statements	The units responsible for the preparation of financial statements (and supervision)	50.0 %
	Information on the process of preparing financial statements (including the internal segregation of duties for preparing financial statements)	37.5 %
	Information on the use of control mechanisms of a technical nature (numerical and logical control formulas) and substantive (analysis of control reports) in the process of preparing financial statements	6.25 %
	Information on the fact that the process of preparing financial statements is described in the internal regulations and in the order of the chairman of the board	18.75 %
	Indication of a committee’s responsibility on disclosures for the correctness of the data contained in financial reports and their compliance with the law	6.25 %
	Information about the adoption of solutions aimed at avoiding incorrect estimates made in accordance with the guidelines of IAS/IFRS	6.25 %

Source: Author’s own compilation

*Percentage of companies presenting an item.

Tabela 6: Detailed disclosures within the ‘Regulations’ group

Disclosure group	Detailed items	%*
Regulations	Information on internal regulations concerning the process of preparing financial reporting (procedures, directives, inventory instructions, lists of duties, material liability, code of ethics, rules, documentation of accounting policy, instructions, detailed procedures concerning e.g., incurring obligations)	12.5 %
	Information on the sources of regulation on financial reporting (Polish Accounting Act, IAS/IFRS, Stock Exchange regulations)	12.5 %
	Information on tracking changes in regulations relating to the preparation of financial statements and interim reports	25.0 %

Source: Author’s own compilation

*Percentage of companies presenting an item.

In the ‘Regulations’ disclosure group banks presented information on the internal regulations related to the functioning of the system of control over financial reporting. Some banks also indicated the regulations which were the basis for preparing financial statements (Tab. 6).

In the ‘External audit’ disclosure group the vast majority (75%) of the surveyed banks indicated that their financial statements were audited by the statutory auditor (Tab. 7).

In the ‘Audit committee’ disclosure group the banks pointed to the tasks which this unit performs in relation to financial reporting (Tab. 8).

Tabela 7: Detailed disclosures within the ‘External audit’ group

Disclosure group	Detailed items	%*
External audit	Information on submitting financial statement for an audit (review) by a statutory auditor	75.0 %
	The process of selection of a statutory auditor (the selection is mostly done by the supervisory board)	37.5 %
	Information on the remuneration of a statutory auditor	12.5 %
	At the meetings of the audit committee, an auditor presents key findings on financial reporting	6.25 %
	Information about the adoption of solutions aimed at avoiding incorrect estimates made in accordance with the guidelines of IAS/IFRS	6.25 %

Source: Author’s own compilation
*Percentage of companies presenting an item.

Table 8. Detailed disclosures within the ‘Audit committee’ group

Disclosure group	Detailed items	%*
Audit committee	The tasks of an audit committee related to the functioning of the system (e.g., monitoring the financial reporting process, monitoring the independence of an auditor, recommending the supervisory board to accept or reject financial statements)	37.5 %

Source: Author’s own compilation
*Percentage of companies presenting an item.

Table 9. Detailed disclosures within the ‘Security and data protection’ group

Disclosure group	Detailed items	%*
Security and data protection	Information on the safety and protection of data from financial reporting	6.25 %

Source: Author’s own compilation
*Percentage of companies presenting an item.

In the ‘Security and data protection’ disclosure group the surveyed banks indicated that they implemented procedures for, e.g. restricting access to data from the accounting system (Tab. 9).

Almost all surveyed banks indicated in the ‘Internal audit’ disclosure group that their unit has a functioning internal audit unit (Tab. 10). It should be stressed that an independent organizational unit responsible for internal audit must operate in banks (Marcinkowska, 2013, p. 265).

Regarding detailed items, 50% or more of the banks surveyed presented information on: the benefits associated with the operation of systems, components of systems, forms of control, units responsible for the preparation of financial statements, external audit, and the company’s internal audit.

An empirical study identified a total of 36 items of detailed disclosures presented by the banks and which concerned disclosures on internal control and risk management systems in relation to financial reporting

(Tab. 1-10). It seems reasonable to question whether the number of detailed disclosures presented by individual banks is related to the size of the bank (measured by interest and commission income generated in a given fiscal year). It turns out that it is not possible to identify such a relationship.

The most detailed disclosures (identified by the author) on internal control and risk management systems in relation to financial reporting were revealed by the BNP Paribas bank. In turn, the lowest number of detailed disclosures (identified by the author) on internal control and risk management systems in relation to financial reporting were provided by Nordea bank.

Tabela 10: Detailed disclosures within the ‘Internal audit’ group

Disclosure group	Detailed items	%*
Internal audit	Information on the company’s internal audit which is involved in risk identification and evaluation of control mechanisms (institutional internal controls implemented by an internal auditor)	93.75 %
	Information about the subordination of internal audit to the management)	31.25 %
	Internal audit department submits to the supervisory board and the audit committee information about any irregularities in the operation of the system	25.0 %
	Information about the existence of the annual internal audit plan	6.25 %
	Internal audit performs an independent assessment of the adequacy, accuracy and efficiency of the internal control and risk management systems	6.25 %

Source: Author’s own compilation

*Percentage of companies presenting an item.

Tabela 11: Detailed disclosures within the ‘Internal audit’ group

Name of the company	Interest and commission income for the year 2011 (in thousands of PLN)	The number of main groups of disclosures *	The number of detailed disclosures **
Powszechna Kasa Oszczędności Bank Polski	15 874 927	5	9
Bank Polska Kasa Opieki	10 338 275	6	8
BRE Bank	5 169 745	8	11
Getin Holding	5 149 837	5	10
Bank Zachodni WBK	4 972 397	6	12
ING Bank Śląski	4 555 600	7	12
Bank Millennium	3 366 850	3	9
Bank BPH	2 939 860	6	8
Bank Handlowy w Warszawie	2 680 123	5	9
Alior Bank	1 323 602	3	8
Nordea Bank Polska	1 190 977	4	5
BNP Paribas Bank Polska	1 181 502	7	13
Bank Ochrony Środowiska	968 398	5	11
Bank Gospodarki Żywnościowej	510 133	4	6
Getin Noble Bank	94 563	7	10
Nova Kreditna Banka Maribor D.D.	90 632	5	6

Source: Author’s own compilation

*Up to 10 main groups of disclosures.

** Up to 36 detailed disclosures.

It was also not possible to identify the relationship between the size of the bank (measured by interest and commission income generated in a given year) and the number of main groups of disclosures on internal control and risk management systems in relation to financial reporting. The most main groups of disclosures were presented by BRE Bank, the least, in turn, by Alior Bank (Tab. 11).

In summary, the results of the study indicate that part of the disclosures do not bring additional value to the reporting process. This concerns disclosures about regulations and external audit. Banks listed on the Warsaw Stock Exchange show in disclosures on control over financial reporting that their financial statements are prepared in accordance with IFRS. This information is also contained in financial statements. In addition, financial statements of all public companies are audited; therefore the disclosure of such general information as crucial from the point of view of control over financial reporting appears to be doubtful. The information that banks use IT tools within the internal control and risk management systems in relation to financial reporting seems vague.

CONCLUSIONS

The results of the study indicate that in 2011, in the reporting practice of the listed banks, there was no uniform reporting form regarding the presentation of

information on internal control and risk management systems in relation to financial reporting.

The disclosures were different both in terms of the degree of detail and the content. In some banks the disclosures were made at a high level of generality. Part of the disclosed information does not bring additional value to the reporting process, for example such general terms as ‘financial statements are audited by a statutory auditor’, when all financial statements of all public companies must be audited.

The study has identified a group of data (concerning control over financial reporting), which were mostly presented by the banks. Most banks describe (in a general or specific way) internal control and risk management systems. Many banks disclose information on a body responsible for the preparation of financial statements; some indicate that it was the management board. The disclosures provide the information that the accounting department is also responsible for the preparation of financial statements. Almost all of the surveyed banks indicated that an internal audit unit operates within the systems of internal control and risk management.

The survey results determine which areas related to internal control and risk management systems are crucial from the point of view of financial reporting in the banks listed on the Warsaw Stock Exchange. The results indicate that this issue requires further, in-depth research.

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