Dean&Francis

ISSN 2959-6130

A Brief Analysis of Internal Control Strategies for Financial Risks in Listed Companies

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Abstract:

In an era of intensifying competition, a more complex socio-economic environment, and rapid technological advancement, financial risks throughout all economic activities of enterprises have become a critical concern. These risks affect not only the stability of individual businesses and financial markets but also the economic security of countries. Effective financial risk control requires a systematic approach and the integration of efforts across various functional departments to ensure stable and sustainable development of enterprises. This paper provides recommendations on managing financial and operational risks based on internal control theories, China's regulatory norms, and perspectives from economics and management.

Keywords: Listed companies; internal control; financial risks; risk management

I. Relationship between Internal Control and Risk Management

COSO (2013) defines internal control as a process implemented by an organization's board of directors, management, and other employees. It is designed to provide reasonable assurance regarding the achievement of operational, reporting, and compliance objectives. COSO (2017) defines risk management as the culture, capabilities, and practices that an organization relies on to manage risk while creating, sustaining, and realizing value, in conjunction with strategy development and execution. The relationship between internal control and risk management is interpreted differently both domestically and internationally. It can be summarized as follows: risk management encompasses internal control; risk management and internal control are considered equivalent; and internal control encompasses risk management. However, there is no universally agreed-upon understanding of how these two concepts relate to one another. Internal control is a broad and grand concept. It was proposed quite some time ago and has now developed into a relatively mature state. The most widely applied and recognized internal control system at present is also the "Internal Control Integrated Framework" published by the American Institute of Certified Public Accountants. It provides a clear definition of internal control, which is a process carried out by the organization's board of directors, management, and other personnel to ensure that, under the condition of complying with applicable laws and regulations, the organization can achieve its business objectives efficiently and effectively, and ensure the reliability of financial reporting.

II. Relationship between Internal Control and Financial Risks

The relationship between internal control and financial risks can be deduced by examining the link between internal control and risk management, and reviewing how financial risk impacts internal control. Specifically, financial risk is one of many risks that enterprises face. Internal control for financial risk involves assessing these risks, identifying relevant issues, and implementing measures to mitigate their impact on financial activities to an acceptable level. Consequently, internal control is a crucial tool for managing financial risk, which is embedded within financial risk management. And the ultimate goal of internal control is to reduce financial risk. The importance of corporate governance structure is also highlighted by the presence of financial risks. Corporate governance structure refers to the organizational structure, power distribution, and decision-making mechanisms among various management levels, functional departments, and stakeholders within a company. A sound corporate governance structure can ensure that the corporate governance bodies (shareholders' meeting, board of directors) and management legally and reasonably exercise their authority over the company's business activities, effectively supervise the company's operations, prevent various risks, and protect the interests of the company and investors. An effective corporate governance structure can encourage the corporate governance bodies (shareholders' meeting, board of directors) and management to be more responsible in fulfilling their supervisory and management duties when facing financial risks. While maintaining the financial stability and sustainable development of the company, they can take timely measures to avoid the expansion of risks. [3]

III. Internal Control Strategies for Preventing and Controlling Financial Risks

The prevention and control of financial risks should be systematic, with each functional department establishing a coordinating mechanism for collective management. Research by E Xiuli (2008) indicates a negative relationship between internal control and financial risks; improved internal control enhances financial early-warning indicators, highlighting the importance of internal control in managing financial risks. This paper proposes recommendations for financial risk prevention and control from three key aspects:

(I) Set tone at the top to enhance the effectiveness of internal control.

The "tone at the top" refers to the attitude of the top management towards internal control, which is a critical component of the control environment. Both China's "Basic Norms for the Internal Control of Enterprises" and COSO's "Internal Control - Integrated Framework" recognize the control environment as the foundation for organizing and implementing internal control, highlighting the importance of control atmosphere to the internal control system. A robust control environment relies on the tone set by the top management, as well as their professionalism and competence. The "tone at the top" underpins the continuous operation of internal control. Independent directors with relevant expertise can add value by providing fair and reasonable suspicion as well as unbiased evaluations. Furthermore, factors influencing the effectiveness of internal control also significantly impact financial risks. Therefore, enhancing internal control effectiveness, based on an improved control environment, is crucial for effective financial risk control.

From the perspective of enterprise type and profitability, the current performance of state-owned enterprises (SOEs) in China tends to be relatively low. This underperformance is linked to their relatively stable work status and issues in internal control such as weak awareness and low-quality talent. To address these issues, it is crucial to strengthen the control environment, enhance the awareness of risk prevention and control, and increase expertise in relevant positions related to internal control. Improving the effectiveness of internal control can help corporate governance, ensure the preservation and appreciation of state-owned assets, and enhance the financial performance of SOEs. Small and medium-sized enterprises (SMEs) in China frequently face shorter lifespans, making robust financial performance crucial for their survival. Scholars suggest that, to enhance the performance of Chinese SMEs, decisive decision-making by the founder or general manager is crucial. Concurrently, other executives must collaborate effectively to implement these decisions. Approaches that are conservative and time-consuming, such as prolonged information communication and feasibility analysis, are often deemed less effective. This paper argues that although experienced managers often make quick decisions based on their experience rather than extended theoretical analysis, a clear division of responsibilities and power is vital. This approach ensures informed decision-making, supports organizational stability, and promotes the smooth flow of internal information. According to Article 5 of Chapter 2 "Organizational Structure Design" in the "Basic Norms for the Internal Control of Enterprises" of China, "major decisions, significant issues, important personnel appointments and removals, and large financial transactions must adhere to established authority and procedures, necessitating collective decision-making or co-signature. No individual should make decisions unilaterally or alter collective decisions without authorization". Article 6 further mandates that "it's necessary to clarify the responsibilities and authorities of each organization, and avoid overlapped functions, gaps, or excessive concentration of powers. It requires establishing a system where each entity performs its own duties, is accountable for its responsibilities, and operates within a framework of mutual constraints and coordination". These requirements align with both national regulations and the concerns of financial risk management theory and principal-agent theory.

(II) Strengthen inter-department cooperation to facilitate communication.

Once an enterprise establishes a comprehensive and robust control environment and assesses the risks associated with its financial objectives, effective inter-departmental communication and the implementation of control activities become critical to mitigating financial risks. Hu Cuiping (2012) explored the transmission mechanisms of financial risks and found that due to the interconnected financial management processes, risks in one area can easily propagate to others. She identified four primary sources of risk: financing, investment, capital management, and revenue allocation. Based on these insights, it is evident that effective communication and high-quality information are essential prerequisites for effective internal control. The COSO "Internal Control - Integrated Framework" and China's "Basic Norms for Internal Control of Enterprises" outline principles for information exchange and communication. For example, Article 40 of Chapter 5 of "Basic

Norms for Internal Control of Enterprises" states that "enterprises should exchange and provide feedback on internal control-related information across all management levels, responsible units, and business processes within the enterprise, as well as with external investors, creditors, customers, suppliers, intermediaries, and regulatory bodies. Issues identified during the information exchange process should be reported and resolved promptly. Important information should be conveyed to the Board of Directors, the Board of Supervisors, and the management in a timely manner".

(III) Pay attention to key business activities and disrupt the risk transmission paths.

1. Internal control of inventory

For inventory management, enterprises should adopt updated technologies and methods tailored to their specific conditions, ensuring a standard management process. It is essential to establish a comprehensive system covering all stages of inventory management, including acquisition, warehousing, processing, and storage. This system should aim to ensure inventory quality and safety, prevent abnormal losses, control costs, and manage risks at every stage. Enterprises should also practice timely procurement and categorized management based on the consumption patterns of different inventories, procurement plans, and production schedules to maintain an adequate supply of inventory. However, a higher inventory turnover rate is not always an advantage. For instance, a high turnover rate might indicate that supply is insufficient to meet demand, leading to potential loss of customers to competitors. Alternatively, it could result from inventory impairment, which reduces the average balance and increases turnover rate. Therefore, enterprises should not only avoid excessive inventory accumulation and enhance inventory liquidity but also focus on developing effective sales plans to maximize production capacity.

2. Internal control of accounts receivable

To mitigate the losses from bad debts, enterprises should clearly define the responsibilities of various departments and establish a comprehensive system for managing accounts receivable. For instance, the sales department should handle the collection of accounts receivable and maintain accurate records of transactions with customers. Meanwhile, the accounting department should be responsible for the recovery and settlement of accounts receivable. Enterprises should leverage information systems to enhance the management and storage of accounts receivable data. This involves tracking and regularly reconciling accounts receivable based on this data. Additionally, it is crucial to manage bad debts effectively by assigning dedicated personnel to employ appropriate collection methods based on the amount and aging of receivables. If all or part of the accounts receivable become uncollectible, the enterprise should promptly investigate the reasons and assign responsibility.

3. Internal control over financing activities

Risks associated with financing activities can propagate in the following manner: inefficiency of borrowed funds → insufficient operating cash → increase in short-term loans → higher interest expenses → inability to repay principal and interest on time. Such risks are particularly pronounced when enterprises over-rely on loans or use high financial leverage, especially when a significant proportion of current liabilities increases the short-term debt repayment pressure. Additionally, some enterprises may resort to borrowing due to low profitability and an inability to support operations with internal funds. This, combined with the inefficiency of borrowed funds, can lead to heightened financial risk. To mitigate these risks, enterprises should clearly define the purposes and methods of financing, paying attention to the distinct risks associated with different financing options. In practice, enterprises must adhere strictly to the approved financing plans, ensuring that funds are utilized according to their designated purposes and procedures.

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