

# Analysis of the Impact of Internal Control on Accounting Information Quality: A Perspective from Adverse Internal Control Opinions

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**Abstract:** *Internal control is fundamental to ensuring the quality of accounting information. This paper examines the impact of internal control deficiencies on the reliability of accounting information from the perspective of adverse internal control opinions. By analyzing the manifestations and causes of these adverse opinions, the study highlights their significant influence on stakeholder decision-making and underscores the urgency of strengthening internal control systems. To enhance internal control, the paper suggests strategies such as improving system design, reinforcing supervision mechanisms, enhancing personnel competence, and optimizing information systems. Only through a coordinated effort across systems, processes, personnel, and technology can a comprehensive and effective internal control defense be established, thereby safeguarding the quality of accounting information and ensuring the long-term stability of capital markets.*

**Keywords:** *Internal Control; Accounting Information Quality; Audit Opinion*

## 1. Introduction

In the wave of economic globalization, as capital markets become increasingly sophisticated and mature, internal control has emerged as a cornerstone of corporate governance structures and a central mechanism of operational management. It plays a crucial role as the gatekeeper in ensuring the authenticity, accuracy, and completeness of accounting information, underscoring its undeniable importance. The robustness of internal controls within publicly listed companies and the transparency of their financial disclosures have become focal points of widespread attention. Much like an immune system, internal control quietly safeguards a company's financial health and the edifice of its reputation. However, it is regrettable that in recent years, frequent financial frauds and scandals have starkly exposed the numerous vulnerabilities and failures in the internal controls of some publicly listed companies. These scandals not only brazenly challenge the principle of integrity but also directly question the effectiveness of internal controls. They resemble sudden storms that disrupt the previously calm capital markets, casting significant doubt on the authenticity of accounting information and the reliability of capital markets.

When the deficiencies in internal control are severe enough to prompt auditing firms to issue adverse opinions, it acts as a seismic shock. This not only profoundly reveals the deep-seated crises of internal control failures but also delivers a heavy blow to the credibility of accounting information and the stability of capital markets. Consider the implications for a publicly listed company labeled as having "failed internal controls": how credible can its accounting information remain? What will become of investor confidence? How can the healthy development of capital markets be ensured in such circumstances?

## 2. The impact of internal control on the quality of accounting information: An analysis from the perspective of adverse opinions on internal control

The design and operation of a company's internal control are of significant interest to regulatory bodies, external information users, and the accounting and auditing research community<sup>[1]</sup>. An adverse opinion on internal control, typically highlighted in a separate paragraph of the audit report, indicates major deficiencies in a company's internal control system. This opinion underscores the failure of

internal controls and reveals the potential risk of significant misstatements in financial reports. As a crucial part of the audit report, the adverse opinion prominently communicates the severity of internal control deficiencies, urging management to implement effective corrective measures. This ensures the quality of accounting information and supports the healthy and orderly development of capital markets [2].

### ***2.1. Manifestations of Adverse Opinions on Internal Control***

Adverse opinions on internal control play a crucial role in disclosing risks to the public and conveying market warning signals. These opinions are manifested in several key ways:

#### ***2.1.1. Explicit Expression of Adverse Opinions***

Auditors explicitly articulate adverse opinions in their internal control audit reports. This expression typically highlights significant deficiencies in one or more aspects of a company's internal control, which may lead to substantial potential misstatements in financial reports. For instance, in 2023, PricewaterhouseCoopers issued a disclaimer of opinion for ST Tianchuang, accompanied by an adverse opinion on internal control, primarily due to issues in the fair value assessment of a subsidiary's equity transfer transaction.

#### ***2.1.2. Identification of Specific Areas with Major Deficiencies***

After the audit, if certified public accountants (CPAs) find that there are significant deficiencies in the internal controls of a publicly listed company that prevent them from providing sufficient assurance, they will issue a negative opinion, usually detailing the specific areas where the significant deficiencies leading to the negative opinion are located. These significant deficiencies may include, but are not limited to, the preparation of financial reporting, investment and financing management, related party transactions, sales and receivables, internal control environment, fund management, non-compliant guarantees, contract management, procurement and payment, and several other aspects.

For example, in transactions between Qiulin Group and its related party, Huangjia Precious Metals Co., the failure to adhere to the decision-making and authorization procedures outlined in related-party transaction management policies resulted in a transaction amounting to 20 million yuan, which was not promptly identified and disclosed. Such uncontrolled related-party transaction management directly affects the integrity and disclosure accuracy of related-party transactions in financial statements.

#### ***2.1.3. Emphasis on the Impact on Financial Reporting Reliability***

A negative opinion on internal control will emphasize the significant impact of these material weaknesses on the reliability of financial reporting. Due to significant deficiencies in internal control, financial reports may fail to truly and accurately reflect the financial condition, operating results, and cash flows of the enterprise, thereby reducing investors' trust in financial reporting, affecting the compliance and effectiveness of financial data, and impacting the company's refinancing and equity incentive programs, among other things. A negative opinion on internal control has a direct and profound impact on the reliability of financial reporting; it is not only related to the authenticity and accuracy of the financial reports but also to the overall reputation and market performance of the company.

#### ***2.1.4. Provision of Improvement Recommendations***

Alongside issuing adverse opinions on internal control, auditors typically offer a series of improvement recommendations. These suggestions may include strengthening internal audit and supervision mechanisms, enhancing management and employee awareness of the importance of internal control, and maintaining close communication with auditors. Such recommendations aim to assist companies in identifying and rectifying significant deficiencies in their internal control systems.

### ***2.2. Analysis of the Causes of Adverse Opinions on Internal Control***

The formation of adverse opinions on internal control often results from the interplay of multiple factors.

#### ***2.2.1. Management Negligence and Governance Lapses***

The root causes of internal control failures can frequently be traced back to management negligence and governance lapses. These issues manifest in several ways: (1) Lack of risk awareness. Managers

lack sufficient understanding and vigilance against potential risks, failing to timely identify and address risk factors that may negatively impact the company's operations;(2)Lax control environment. The control environment is the foundation of internal control, encompassing the company's management philosophy, operating style, organizational structure, responsibility allocation, and human resource policies. A lax control environment undermines the effectiveness of internal control, making it difficult for internal control measures to be effectively implemented.

### ***2.2.2. Inadequate Institutional Framework***

Deficiencies in the institutional framework, such as incomplete design, lack of rigorous processes, and unclear role delineation, can lead to numerous internal control vulnerabilities and overlooked risks<sup>[3]</sup>. Specific manifestations are as follows:(1)Inadequate design. The internal control system fails to cover all important business processes and links within the company, resulting in certain areas becoming blind spots in regulation;(2)Lack of rigor in processes. The design of business processes is either unreasonable or overly complex, which can easily lead to operational errors and fraudulent activities;(3)Unclear division of responsibilities. The division of job responsibilities is not clear, leading to issues such as shirking of responsibilities and abuse of power.

### ***2.2.3. Ineffective Implementation of Internal Control Systems***

Even the most well-designed internal control systems are rendered ineffective if not properly implemented. This is evident in several ways: a lack of compliance awareness among employees, insufficient understanding of the importance of internal controls, and frequent occurrences of non-compliant operations; the supervisory mechanism is ineffective, with internal oversight bodies such as the audit department and risk management department failing to perform their duties effectively, and being unable to detect and correct deviations in a timely manner.

## ***2.3. Impact of Adverse Opinions on Internal Control***

### ***2.3.1. Impact on the Reliability of Accounting Information***

When internal control activities become ineffective and fail to perform their critical role in preventing fraud and errors, the authenticity and accuracy of accounting information face significant challenges. The failure of internal controls allows fraudulent activities to proliferate unchecked. In crucial business processes such as sales and collections, as well as procurement and payments, inadequate control can lead to the emergence of fraudulent revenue and fictitious costs. These violations not only disrupt the fair competitive environment of the market but also pose a serious threat to the authenticity and accuracy of accounting information, making it difficult for investors to obtain accurate and reliable financial data necessary for informed investment decisions.

Moreover, the lack of proper regulation in fund management is another severe consequence of ineffective internal controls. As the core of a company's financial activities, the regulation of fund management is directly related to the security and stability of corporate finances. However, when fund management does not adhere to relevant protocols and irregularities occur, it opens the door to financial misappropriation or misuse. Such practices not only undermine the financial health of the enterprise but also severely impact the authenticity and reliability of accounting information. Additionally, the absence of necessary review mechanisms during the preparation of financial reports removes a critical line of defense, significantly increasing the risk of misstatements. This series of internal control deficiencies undermines the credibility of accounting information, potentially leading investors into unforeseen investment pitfalls due to inadequate decision-making.

### ***2.3.2. Impact on Stakeholder Decision-Making***

For investors, the failure of a company's internal control undoubtedly triggers a series of intense reactions and deep concerns. These concerns primarily stem from two aspects: one is the doubt cast on the authenticity of accounting information. Investors rely on truthful and reliable financial information to make investment decisions. Once internal control issues arise, the reliability of accounting information is severely questioned, making it difficult for investors to ascertain the company's true performance and prospects; the other is the fear of the company's financial condition deteriorating. The failure of internal control may indicate problems such as management chaos and resource waste within the company, which could gradually accumulate and lead to the deterioration of the company's financial condition. Faced with these risks and uncertainties, investors' confidence is significantly diminished, prompting them to withdraw their funds, resulting in a sharp decline in share prices and further exacerbating market panic.

In addition to investors, creditors also express concerns about deficiencies in a company's internal control. Such deficiencies may indicate inadequacies in various aspects such as financial management, risk management, and asset management within the company. These inadequacies not only reduce the company's operational efficiency but may also directly impact its solvency and credit standing. For creditors, a company's solvency and credit standing are crucial factors in assessing loan risks. Once these aspects are compromised, it signifies that the safety of creditors' funds is threatened, increasing the risks of default and bankruptcy. Furthermore, a negative opinion on internal control attracts close attention and inquiries from regulatory authorities, which not only imposes additional regulatory pressure and costs on the company but may also trigger a series of chain reactions such as damage to the company's reputation and management turmoil, further intensifying creditors' concerns and unease.

### ***2.3.3. Impact on the Company Itself***

Firstly, there is reputational damage. A negative opinion on internal control from an audit institution is an extreme negative evaluation of a company's internal control status, often indicating significant deficiencies in the company's internal control system. This system is unable to effectively ensure the reliability of financial reports, the safety and integrity of assets, and the compliance of operations. This will severely damage the company's reputation and image, leading to a decrease in trust from investors, partners, and regulatory agencies, which in turn will affect the company's business cooperation and development. Secondly, there may be stock price fluctuations. Once news of a negative opinion on internal control is made public, it is likely to spark investor panic, causing the company's stock price to fall sharply. Such fluctuations not only affect the company's market value but may also cause significant losses to investors. Thirdly, operational efficiency may decline. An effective internal control system helps improve a company's operational efficiency. However, a negative opinion on internal control indicates deficiencies in the company's internal control system, unable to provide strong support for this goal, thereby leading to a decline in the company's operational efficiency. Additionally, the company may face stricter regulatory requirements. Internal control failures often come with higher fraud risks, so regulatory agencies will give special attention to such companies, including regular reporting, rectification measures, etc., to ensure that their internal control is effectively improved. Finally, there are legal responsibilities. If the company commits illegal acts or produces distorted financial reports due to internal control deficiencies, the company and its relevant personnel may need to bear corresponding legal responsibilities, including but not limited to fines, compensation, and criminal liability investigations.

In conclusion, the trust crisis triggered by internal control deficiencies can overturn stakeholders' existing judgments, alter decision-making paths, and exacerbate the company's operational difficulties.

## **3. Implementation Strategies for Internal Control**

### ***3.1. Enhancing the Design of the Internal Control System***

Establishing a comprehensive, systematic, and effective internal control framework is a crucial measure for strengthening the foundation of corporate governance. To achieve this, it is essential to adhere to a risk-oriented approach by first thoroughly identifying and assessing operational risks. Based on this assessment, corresponding control activities should be designed to keep risks within an acceptable range. Additionally, a goal-oriented strategy should be implemented, focusing on strategic objectives and developing a hierarchical and interconnected system of control objectives. This ensures that internal control measures are both targeted and effective. Furthermore, the principle of comprehensiveness must be followed by embedding internal control into every aspect of corporate governance and business processes. This approach creates an all-encompassing internal control network that includes preventive measures before events, control during events, and supervision after events. Simultaneously, the cost-effectiveness of the internal control system should be considered, enhancing the economic viability and operability of the control design while meeting compliance requirements. Moreover, the design of the internal control framework should reflect foresight and dynamic optimization, allowing for timely adjustments and improvements in response to changes in internal and external environments. This ensures the adaptability and effectiveness of the internal control system.

### ***3.2. To enhance the internal control supervision mechanism***

It is essential for the internal audit department to clearly define its responsibilities and maintain an independent and objective stance in conducting internal control audits. This involves a comprehensive

assessment of the effectiveness of internal control design and execution, identifying potential deficiencies and risks, and ensuring timely rectification. To safeguard the independence and authority of the internal audit function, the department should be granted adequate organizational status and resource support, with a direct reporting line to the audit committee to prevent managerial interference. Furthermore, the internal audit process should adopt a risk-oriented approach, concentrating on key areas, critical processes, and high-risk issues to enhance the specificity and effectiveness of audit supervision. Establishing a coordination mechanism with external auditors is also crucial, facilitating the exchange of information on internal control deficiencies and fostering a collaborative oversight effort. Internal control supervision should not be limited to internal audits alone; it should also incorporate self-assessment by management and self-inspection by business units, embedding internal control evaluation into daily management for continuous monitoring. Additionally, it is important to establish clear internal reporting channels to encourage employees to report violations of internal controls, thereby fostering a culture of collective participation in supervision.

### ***3.3. Enhancing the Quality of Internal Control Personnel***

Firstly, enhancing the professional competence of internal control personnel is a multidimensional and comprehensive process that necessitates a focus on multiple crucial stages, including selection, cultivation, assignment, and retention. By establishing scientific criteria for selecting talent, we can introduce excellent individuals who possess both internal control expertise and practical experience, thereby injecting new vitality into internal control work. Subsequently, it is imperative to emphasize the continuous learning and professional development of internal control personnel by providing systematic training and development opportunities. These efforts will assist them in constantly updating their knowledge base, enhancing their business capabilities, and improving their professional qualifications. Secondly, strengthen internal control training by offering targeted programs in business skills and professional ethics to improve the personnel's professional standards and overall competence<sup>[4]</sup>. Lastly, it is also imperative to foster a corporate culture that respects internal control and emphasizes compliance, strengthening integrity education. Through regular integrity training, case analysis, and setting up positive examples, we can help employees establish correct moral values and professional ethics, making integrity the solid foundation for enterprise development. On this basis, the company further needs to enhance the self-consciousness of all employees in participating in internal control. By clarifying job responsibilities, implementing reasonable incentive mechanisms, and establishing transparent oversight systems, we can stimulate employees' enthusiasm for participating in internal control, making every employee a guardian and promoter of the enterprise's internal control system.

### ***3.4. To enhance the financial information system***

The company should integrate automated internal control rules to seamlessly merge business processes with control procedures, thereby reducing human intervention and strengthening system constraints to prevent violations at the source. First, the company should establish comprehensive lifecycle management for the information system, covering all stages from requirements analysis and design development to deployment and maintenance, to ensure reliable system operation. Second, data governance should be prioritized by improving master data management and standardizing data collection, transmission, storage, and application processes to ensure the integrity, consistency, and security of accounting data. Additionally, the company should embrace emerging technologies, leveraging big data analytics and artificial intelligence to deeply analyze financial data, promptly alert to anomalies, and extend internal control from post-event to proactive and ongoing measures. Finally, optimizing the mobile office platform will facilitate communication and enhance the coordination and timeliness of internal control efforts.

## **4. Conclusion**

The issuance of a negative opinion on internal controls serves as a stern warning of the failure in a company's internal control mechanisms, highlighting significant management oversights. In response to this critical challenge, the company must prioritize and deeply reflect on these issues. It should work on improving the design of its internal control system to ensure compliance, transparency in business processes, and effective risk prevention. Strengthening both internal and external audit mechanisms will enhance the company's management standards and rigor. Additionally, the company needs to focus on improving employee qualifications, intensifying internal control training, and fostering compliance and risk awareness among staff. Optimizing information system development and leveraging modern

technology will further enhance internal control efficiency, ensuring the authenticity and reliability of accounting information. Through these comprehensive measures, the company can effectively address internal control weaknesses and lay a solid foundation for stable development.

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