

# Research on the Optimization of Internal Controls in Listed Companies—A Case Study of Company A

*Liu Qi*

School of Accounting, Hebei University of Economics and Business, Shijiazhuang, Hebei 050000

15633563368@163.com

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**Abstract.** In the current fierce market competition, if a company wishes to enhance its competitiveness, it must improve the work efficiency of its employees and the quality of its products. Simultaneously, the significance of internal controls lies in ensuring the reliability of financial reports, and the authenticity and accuracy of accounting information. Robust and effective internal controls are vital in preventing financial fraud within companies. This paper selects company A, a company that received an adverse opinion in its 2022 internal audit report, as a case study. By discussing its current state of internal controls and analyzing the issues in the five elements of internal control, which include (1) a weak internal environment, (2) poor risk assessment capabilities, (3) lack of control activities, (4) delayed information and communication, and (5) ineffective internal monitoring. Based on the issues identified in the case study, this paper proposes recommendations for improving internal controls in listed companies, aiming to provide references for business development.

**Keywords:** internal control, related party transactions, improvement suggestions

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## 1. Introduction

Internal control refers to the policies and procedures designed and implemented by the governance, management, and other personnel of the audited entity to reasonably ensure the reliability of financial reports, operational efficiency and effectiveness, and compliance with laws and regulations. Alongside the rapid development of the global economy, businesses face fierce market competition, with simultaneous opportunities and challenges. Thus, the construction of internal controls has become a core issue for enterprises. How to strengthen the management of internal controls to effectively promote business development has become a focal point of our attention.

If internal controls can be effectively established and correctly executed, they can create a favorable internal management environment for enterprises, greatly enhancing their core competitiveness and achieving strategic goals in the fierce market competition. Company A, once a leader in the photovoltaic industry and hailed as "the first stock for photovoltaic poverty alleviation," has had its development prospects questioned due to internal issues. It began to suffer losses in 2018 and continued to do so for four consecutive years. On May 31, 2022, company A was issued a risk warning due to problems such as related-party transactions occupying funds. Its internal audit report for 2022 received an adverse opinion, indicating significant issues with its internal controls. This paper analyzes the deficiencies in the internal controls of the case study company, company A, and proposes targeted and practical improvement measures to promote the sustainable and healthy development of the enterprise.

## 2. Overview of Company A

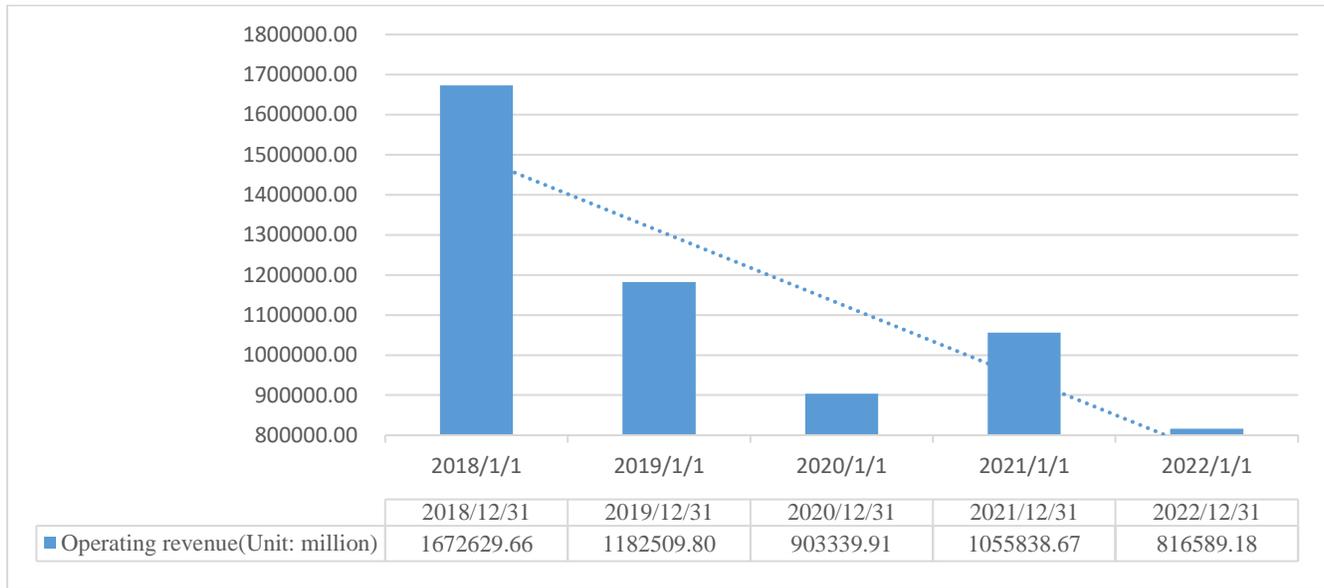
### 2.1. Organizational Structure

Company A has established a General Meeting of Shareholders, a Board of Directors, and a Supervisory Board, which are the company's authority, decision-making, and supervisory bodies, respectively. These form a standard corporate governance structure with established deliberative rules, clearly defining the responsibilities and authority for decision-making, execution, and supervision. The Board of Directors consists of nine members, including one chairman and one vice-chairman. Under the Board of Directors, there are committees such as the Strategy Committee, Audit Committee, Compensation and Assessment Committee, and Nomination Committee, which perform their duties in accordance with the detailed rules of the Board's committees, providing

advice, references, and support for the Board's scientific decision-making. The Supervisory Board oversees the Board of Directors. The management layer is responsible for the formulation and effective implementation of internal control systems. The company management and its functional departments manage day-to-day affairs.

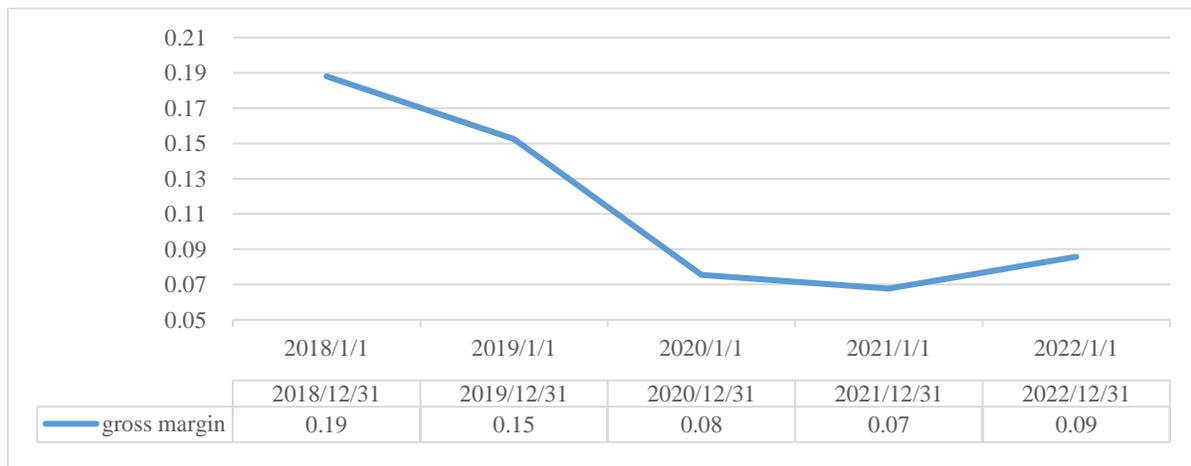
## 2.2. Business Conditions

**Figure 1.** Company A's Operating Revenue from 2018 to 2022 <sup>1</sup>



Operating income is the main business outcome for the enterprise and is an important safeguard for generating profits. Company A's operating income from 2018 to 2022, except for a slight rebound in 2021, showed a downward trend overall, sharply decreasing from 1,672,629.66 million yuan in 2018 to 816,589.18 million yuan in 2022, a decline of 51.18%. This reflects a downward trend in the company's business conditions, which are not optimistic, and the company faces multiple difficulties and challenges.

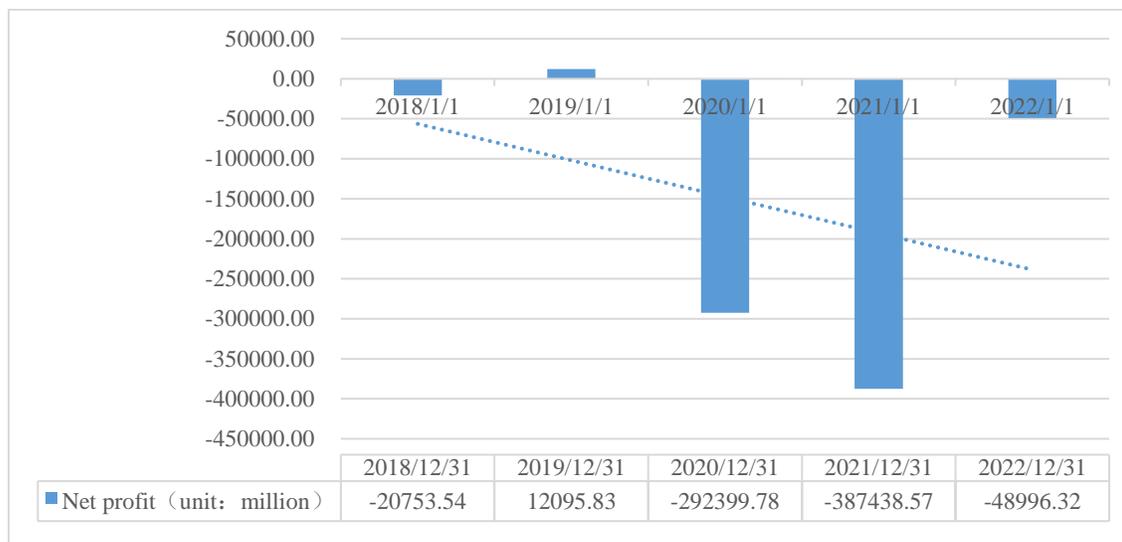
**Figure 2.** Company A's Gross Margin from 2018 to 2022 <sup>2</sup>



The gross profit margin reflects the competitiveness of the company's products in the market and is a direct representation of the core business's profitability. Company A's gross profit margin continued to decline from 2018 to 2021, from 0.19 to 0.07, with a slight increase to 0.09 in 2022, overall showing a downward trend, indicating a decline in company A's profitability.

<sup>1</sup> Data source: Company A Annual Report 2018-2022

<sup>2</sup> Data source: ST Zhongli Annual Report 2018-2022

**Figure 3.** Company A's Net Profit from 2018 to 2022 <sup>3</sup>

As shown in Figure 5, from 2018 to 2021, company A experienced losses in all years except 2019, casting doubts on the company's prospects and sustainability. Its net profit for 2022 was -48,996.32 million yuan. Company A attributed this to the impact of tight operating funds during the reporting period, which hindered capacity release, adversely affecting order fulfillment and product sales, as well as a significant increase in the prices of silicon material, a main raw material for photovoltaic cells and modules compared to the previous year. This led to increased procurement costs for previously signed orders, significantly impacting order profitability.

### 2.3. Current Status of Internal Controls

**Table 1.** Audit Opinion of Company A from 2018 to 2022 <sup>4</sup>

year	Audit opinion
2018	Unqualified opinion
2019	Unqualified opinion
2020	qualified opinion
2021	qualified opinion
2022	qualified opinion

From 2020 to 2022, the accounting firm issued audit reports with qualified opinions for company A. On May 10, 2023, the Shenzhen Stock Exchange sent an inquiry letter to company A regarding the "annual report disclosure, stating that the 2022 financial report audit opinion included an emphasis of matter section with a non-standard opinion, primarily concerning related party transactions, including court pre-restructuring, investigations by the China Securities Regulatory Commission into your company and its controlling shareholder. Additionally, the annual audit accountant issued a negative opinion audit report on internal controls, mainly involving related party transactions and irregular guarantees."

Company A's operations are quite irregular. Its 2021 annual report was issued an audit report with qualified opinions, mainly concerning the full disclosure of related party transactions by the controlling shareholder. In 2021, the accounting firm issued a negative opinion on the company's internal control attestation report. The 2022 internal control audit report also received a negative opinion. The reasons for the negative opinions included two items.

One was unauthorized and unapproved non-operational funds transactions with related parties: in 2022, company A did not effectively implement regulations to prevent non-operational funds occupation by related parties. Multiple non-operational financial transactions occurred between company A and related parties without approval by the company's board of directors or shareholders' meeting, nor were they disclosed in a timely manner as per company regulations. As of December 31, 2022, related parties occupied non-operational funds amounting to 167,480.86 million yuan from company A without paying interest. The financial reporting of these non-operational transactions between company A and related parties revealed significant loopholes in its internal control systems. Another issue was irregular guarantees: Company A had two irregular guarantee incidents from

<sup>3</sup> Data source: Company A Annual Report 2018-2022

<sup>4</sup> Data source: ST Zhongli Annual Report 2018-2022

previous years, with an outstanding guarantee balance of 33,683.15 million yuan at the end of 2022, creating significant deficiencies in the financial statements' internal controls.

The company's largest shareholder caused illegal occupation of the company's receivables and prepayments amounting to 890 million yuan through borrowing from the company's suppliers and customers, leading to short-term unrepayable debts, resulting in ST. On May 31, 2022, the group's stock trading was subjected to additional risk warnings. As of December 31, 2022, the company's controlling shareholder still occupied 1.675 billion yuan of its funds.

### 3. Problems and Causes in Company A's Internal Controls

#### 3.1. Weak Internal Environment

The condition of internal controls directly affects the effectiveness of an enterprise's governance structures and is closely linked to the strategic goals of the enterprise. Concurrently, the completeness of the internal control environment directly impacts the conduct of management activities. Company A's failure to timely identify and announce the aforementioned related-party fund occupations or transactions indicates that the actual controllers of company A supersede its internal controls, revealing a weak internal environment with numerous issues. These include a lack of management responsibility: the controlling shareholder has repeatedly misappropriated company A's funds without notifying the company, bearing full responsibility for these actions. company A has internally criticized the controlling shareholder and imposed a fine of one million yuan. The management's failure to promptly detect multiple large-scale misappropriations by the controlling shareholder indicates a lack of diligence and the need to strengthen their sense of responsibility.

#### 3.2. Weak Risk Assessment Capabilities

Risk assessment permeates the entire operational process of a company, serving not only as an important component of the internal control system but also as a key target for many enterprises implementing internal controls.

##### 3.2.1. Irregular Guarantees

In recent years, irregular guarantees have become a major method for controlling shareholders and related parties to deplete listed companies. Enterprises should pay special attention to such behaviors and effectively assess and address the related risks. Without the deliberation of the Board of Directors or the General Meeting of Shareholders, nor disclosure to the public, the controlling shareholder provided joint liability guarantees for other companies under the "Equity Acquisition Agreement," constituting irregular guarantees. According to company A's 2022 internal control audit report, as of December 31, 2022, the balance of irregular guarantees stood at 336,831.50 million yuan, showing that company A failed to timely and effectively identify corresponding risks.

##### 3.2.2. Subsidiaries Caught in Litigation

Company A's subsidiaries have been involved in multiple litigations, with the core subsidiary's litigation amounting to approximately 400 million yuan since 2023, exerting significant financial pressure on company A. As reported in the annual reports from 2018 to 2021, four of these five years resulted in losses, indicating a pessimistic situation. Company A did not timely assess risks or effectively respond to the numerous lawsuits involving its subsidiaries, reflecting issues in its risk assessment mechanisms.

#### 3.3. Missing Control Activities

Company A's prepayments to suppliers resulted in occupied funds amounting to 1.556 billion yuan, with an increase of 679 million yuan involving nine enterprises. Additionally, equity transfers at photovoltaic power stations resulted in occupied funds of 148 million yuan. During transaction execution, without fulfilling internal resolution procedures, its subsidiaries signed "Supplementary Agreements for Equity Transfer Payments" with other companies and "Designated Payment Orders" with project companies, paying 550 million yuan out of 660 million yuan borrowed to company B (An affiliate company of company A), controlled by the controlling shareholder. Company A paid for Company B' past loan principals of 77.74 million yuan and loan interest of 70.0647 million yuan, totaling 148 million yuan in funds occupied by Company B. In 2022, Company A had multiple non-operational financial transactions with related parties but failed to disclose the occupation of non-operational funds by related parties in the annual report as required by company regulations, showing the ineffectiveness of its control activities.

At the same time, Company A's cost control has been inadequate, with continuous losses in recent years. The company was affected by a long-term shortage of silicon material, a major raw material for photovoltaic cells and components, and significant price increases compared to the previous year, leading to increased procurement costs for previously signed orders and significantly impacting order profitability. Facing rising raw material costs, it could enhance internal control of costs by raising cost awareness among employees and analyzing suppliers, but Company A did not adopt effective measures to address this, indicating that its

control activities were inadequate.

### 3.4. Delayed Information and Communication

In November 2022, Company A and its controlling shareholder were investigated by the China Securities Regulatory Commission for suspected violations of information disclosure laws and regulations, highlighting issues in its information disclosure. Effective internal controls should provide reasonable assurance for the truthfulness and completeness of financial reporting and related information. Company A encountered issues with non-operational funds occupied by related parties but failed to fulfill its information disclosure obligations regarding related-party transactions, exposing significant lapses in information and communication.

### 3.5. Ineffective Internal Supervision

In its 2022 self-assessment report, Company A identified two major deficiencies in internal controls related to financial reporting: non-operational financial transactions with related parties were not approved by the Board of Directors or the General Meeting of Shareholders, and the company was involved in irregular guarantees. Although Company A has an Audit Committee, it failed to timely detect significant deficiencies in internal controls, rendering its supervisory work superficial and ineffective. The enterprise's internal control system has not effectively performed its supervisory and preventive functions.

## 4. Suggestions for Improving Internal Controls

### 4.1. Improving the Internal Environment

#### 4.1.1. Focus on Corporate Culture Development

The effectiveness of a company's internal control system relies not only on the quality and capabilities of the management but also on the culture of the enterprise. Corporate culture, as a part of the internal control environment, has a significant influence within the control framework. A strong corporate culture can provide a favorable atmosphere for the effectiveness of internal control work and has a substantial impact on the quality of accounting information. However, in practical management processes, the impact of corporate culture on the implementation of internal control systems is often overlooked. Therefore, enterprises should pay more attention to developing corporate culture, sort out their own corporate cultures, and provide sufficient resources to address weak links and deficiencies, thereby enhancing their maturity and systematization, creating a refined corporate culture and correct values, and thereby crafting a matching internal control system.

Furthermore, enterprises should focus on cultivating employees' ethical values and legal awareness. This can be achieved by conducting internal control-themed activities to promote the internal control philosophy and culture, enhance employees' understanding and appreciation of internal control tasks, actively play a guiding role, strengthen their sense of belonging, and thereby significantly enhance the effectiveness of enterprise internal controls.

#### 4.2.2. Strengthen Management's Sense of Responsibility

Only with the overall improvement of the executive team can the control environment be fundamentally enhanced, and the management level of the enterprise can be essentially elevated. The overall quality of the management fundamentally determines the internal control environment of the enterprise. Strengthening the training and supervision of senior management personnel is crucial for effectively enhancing the management level of the enterprise. The company can organize periodic training for management personnel on laws and regulations such as the "Company Law," "Securities Law," and "Guidelines No. 8 on Regulation of Fund Operations and External Guarantees by Listed Companies," to enhance their sense of responsibility, urge them to strictly comply with regulatory rules and company policies, achieve standardized operations, and thereby protect and safeguard investors' interests.

### 4.2. Enhancing the Risk Assessment Mechanism

It is essential to enhance the awareness of risk prevention. Enterprises should strengthen training and perfect the responsibility system, focusing on cultivating employees' awareness of risk prevention and increasing their attention to internal controls. Employees should be emphatically reminded of the enterprise's credit policies and utilize various meetings for imparting risk education, ingraining risk awareness, and providing multi-faceted, comprehensive training and guidance, urging employees to implement these in their specific tasks, thereby genuinely enhancing their risk control capabilities.

For problems encountered by management in daily operational management, the enterprise should conduct in-depth analysis to grasp the essence and prevent similar issues from reoccurring. The company could also establish specific reward and punishment mechanisms; once problems are identified, responsibilities should be seriously pursued to enhance awareness of risk management

and reduce acts that could harm the company's interests due to personal negligence.

#### 4.3. Ensuring the Effectiveness of Control Activities

The company should focus on improving the internal control system. When designing the internal control system, it should consider the characteristics and patterns of the company's governance structure and specifically develop a series of measures, promoting and implementing these from top to bottom. Ensuring the openness and transparency of internal controls is crucial. The enterprise should also ensure the strict implementation of all policies and strengthen the cultivation of internal control awareness among enterprise managers and employees.

Furthermore, enterprise managers should plan the company's management actions holistically, based on the actual situation, and take effective measures to control critical areas effectively, analyze control information during the production process, and promptly adjust and optimize control activities.

#### 4.4. Strengthening Information and Communication

Information and communication play a bridging and bonding role in enterprise internal controls. The "Basic Norms of Enterprise Internal Controls" stipulate that enterprises should establish information and communication systems to clearly define the collection, processing, and transmission of information related to internal controls, ensuring timely communication of information to promote the effective operation of internal controls. Companies can establish multi-level information communication channels to promptly obtain information from suppliers and customers and respond timely, thereby promoting effective management of the authenticity and accuracy of various information and providing genuine bases for management decisions. Regular meetings should be held to enhance communication among employees, management, and various departments, ensuring effective implementation of decisions and supervising their execution.

#### 4.5. Establishing a Robust Internal Supervision Mechanism

Enterprises should adopt various forms of supervision, such as establishing regular and special supervision modes, conducting periodic or irregular inspections, and inspecting the non-operational financial transactions and external guarantees involving the company, related parties, and controlling shareholders to avoid non-operational fund occupations and irregular guarantees by controlling shareholders and related parties, thus forming a comprehensive internal supervision mechanism.

### 5. Conclusion

"Past the wreck, a thousand sails pass by; in front of the sick tree, ten thousand trees blossom." (沉舟侧畔千帆过，病树前头万木春) In the process of business operation and management, internal controls are fundamental safeguards for achieving strategic development, forming the basis and prerequisite for attaining strategic development goals. They play a pivotal role in refining the company's governance structure and in ensuring sustainable development. To secure a position in a fiercely competitive market, enterprises should not solely focus on external environmental changes but should optimize their internal structure, strengthen internal management, continuously enhance management levels, and fortify and improve internal controls. By doing so, enterprises can maximize benefits while gradually enhancing their soft power.

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