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School of Business and Management

Master's in accounting

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Structuring of internal control – a case study

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Abstract

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The aim of this Master's thesis is to find out how should internal control be structured in a Finnish retail company in order to fulfil the requirements set out in the Finnish Corporate Governance Code and to be value adding for the company as well as to analyse the added value that a structured and centrally led internal control can provide for the case company.

The underlying fundamental theoretical framework of the study essentially stems from the theory of the firm; the agent-principal problem is the primary motivator for internal control. Regulatory requirements determine the thresholds that the internal control of a company must reach. The research was carried out as a case study and methodically the study is qualitative and the empirical data gathering was conducted by interviews and by participant observation. The data gathered (processes, controls etc.) is used to understand the control environment of the company and to assess the current state of internal control. Deficiencies and other points of development identified are then discussed.

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Tämän pro gradu -tutkielman tavoitteena on ymmärtää miten sisäinen valvonta tulisi strukturoida suomalaisessa vähittäiskaupan yrityksessä siten, että se täyttää Suomen listayhtiöiden hallinnointikoodissa asetetut vaatimukset sisäiselle valvonnalle, on myös lisäarvoa tuottava case yritykselle. Tutkimuksen teoreettisen viitekehyksen lähtökohtana on yritysteoria ja tarkemmin ottaen agentti-päämiesongelma, joka on ensisijainen motivaattori sisäiselle valvonnalle. Lainsäädäntöön littyvät vaatimukset määrittävät ne raja-arvot, jotka yrityksen sisäisen valvonnan tulee vähintään täyttää. Tutkimus suoritettiin tapaustutkimuksena, metodologisesti tutkimus on kvalitatiivinen ja empiirisen datan keruu tapahtui haastatteluin sekä osallistuvan havainnoinnin avulla. Kerättyä tietoa (prosessit, valvontatoimenpiteet ym.) käytetään yrityksen valvontaympäristön ymmärtämiseksi sekä sisäisen valvonnan nykytilan arvioimisen välineenä. Tutkimuksen lopuksi havaittuja puutteita sekä muita kehityskohteita käydään läpi.

Preface

I would like to offer my sincerest gratitude to the people that helped me through this, at times, very rocky road of writing a Master's thesis, especially my wife Susanna.

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At times the task at hand seemed unsurpassable, yet here I am, thanks to the relentless encouragement of family, friends and university staff.

A commonplace platitude is in order, *per aspera ad astra!*

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1 Introduction

1.1 Background of the study

Public interest in internal control has probably never been at a higher level. The reason for the heightened interest lies in the aftermath of massive corporate accounting scandals that have emerged especially since the beginning of the 21st century. The scandals that caught the world's eye and triggered the wider discussion over corporate governance were Enron (2001) and Worldcom (2002). Both of the companies were world-record braking (biggest bankruptcies in history) and took place in the United States within a fairly short period of time. The scandals shook investors' confidence in the US stock market and undermined public trust on business world. The Enron scandal especially, truly first of its kind, provoked public outrage in the United States as investors lost their money and countless workers lost not only their livelihood but pensions also when the company went bankrupt. (Gordon, 2002, pp. 1233-1250; Brickey, 2003, p. 3)

Major accounting scandals of the 21st century in the developed world have not solely been delimited to the United States, as Europe and Japan have also seen their share of accounting fraud and poor corporate governance. The most prominent case in Europe was that of dairy giant Parmalat in 2003, in which the company owners funnelled over 1,5 billion euros worth of assets out of the company, understated liabilities and simultaneously inflated assets (Melis, 2005, pp. 482-484, 487). The driving force behind the scandal was personal gain, as the largest shareholding Tanzi family treated the company as their personal piggybank. The Parmalat case and a few other major European corporate governance failures in the early 2000's signalled that all was not well in Europe either.

The consecutive corporate governance failures of new millennium have made apparent the need for better internal control and auditing. The scale of ramifications of the major scandals in the 21st century has been a reminder to the public of the risk that poor corporate governance presents for the stability and growth of even highly developed and centralized markets as well as the economic well-being of “average Joes”, should a major company fail. As a result, United States enacted the Sarbanes-Oxley Act (SOX) in 2002, which sets very high standards on internal control and auditing (Deakin & Konzelmann, 2003). Simultaneously Europe had started to modernize its corporate governance and company law in the early 2000’s, to which the developments in the US which have had clear implications. Europe has therefore also overhauled some regulation on internal control and auditing (ECOFIN Council, 2004). Japan joined the movement after the Olympus scandal, as it introduced a corporate governance code in an effort to mitigate the problems in the Japanese corporate governance culture. The code has been in effect from June 2015 (Japan Exchange Group, 2015).

The new regulation on internal control and auditing has only naturally sparked colourful debate on the pros and cons of the new and tightened requirements. The United States has been a trailblazer in matters internal control, as the SOX lays out a very standardized and strict demands on internal control and auditing. Being the world’s largest economy and having a long history of minimizing corporate regulation the new rules have led to a plethora of research, especially on internal control (e.g. Zhang, 2007; Ogneva et al., 2007; Leuz, 2007; Hay et al., 2008; Hogan & Wilkins, 2008; Gompers, 2003).

Internal control has traditionally been defined in professional accountancy literature as accounting controls and concern measures within companies, such as segregation of duties, authorization policies, organization structure,

asset and information protection measures, and credibility tests (Maijoor, 2000, pp. 104-105). A broader view, the COSO (Committee of Sponsoring Organizations of the Treadway Commission) internal control framework defines internal control as "*a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives*" (Zhang et al., 2007, pp. 302-304).

The broader view therefore promotes a more value-added perspective as it implies that internal control is instrumental for a successful company in achieving its targets. This study aims to investigate how internal control should be structured in order to fulfil the regulatory requirements laid out for a listed company in Finland. The structuring of internal control was conducted in a company as a case study, seeking to understand how the structuring should be carried out to fulfil regulatory requirements but also to understand the potential value adding perspectives of structured internal control. The underlying argument is that internal control should be seen as an asset rather than a mere self-serving cost centre, whose main purpose is to "tick the regulatory requirement box". The study asserts that the potential may lie in centrally managing internal control, which could provide a meaningful channel for discovering intra-company synergies and a tool for communicating best practices.

1.2 Research objectives and research questions

The main objective of the study is to structure and define internal control in a case company, a large retailer. The intent of the case company is to fulfil the requirements for internal control as construed in the Finnish Corporate Governance Code aimed at listed companies.

The primary research question can therefore be expressed in the form of a question as follows:

- How should internal control be structured in the case company in order to fulfil the requirements set out in the Finnish Corporate Governance Code and to be value adding?

There are prerequisites for the successful structuring of internal control as policies, processes, principles etc. need to be laid down. Furthermore, understanding and managing internal controls of the company entails identifying, documenting and depicting key processes, controls and other risk management within the company. This mapping out needs to be performed at a relatively wide scale, as all operative controlling is performed in the responsible business units. The present state of internal control and processes within the case company is then assessed after the initial definition and structuring has taken place. Possible internal control weaknesses, process bottlenecks, opportunities for performance enhancements and further development needs are analysed and reported based on the assessment.

The secondary research questions can be formed as questions accordingly:

1. What additional value can internal control structuring in the case company produce?
2. What internal control development needs can be identified in the case company?

The answer for the primary research question is sought through the secondary problems. The theoretical part seeks to lay down a framework to fulfil the demands in the Finnish Corporate Governance Code, taking into account the objective of value-adding and cost-effectiveness. The framework defined in the theoretical part is then put in use within the

structuring of internal control in the company in the empirical part of the study.

The answer to the secondary problems is first sought in the context of internal control literature. Theorems and findings of literature are reflected with observations from the case company in the empirical part of the study.

The third secondary research question is primarily answered by analysing empirical data gathered during internal control structuring of the company.

1.3 Delimitations

This study recognizes internal control in a broad sense: internal control comprises all control activities, risk management activities and activities verifying the effectiveness of existing controls (i.e. internal audit). As internal control is a part of corporate governance the theme is explored from an internal control point-of-view to understand the history and context of internal control.

The Finnish Corporate Governance Code is used as the basis for internal control requirements, other corporate governance regimes (such as SOX in the US) are only referred to for the sake of crude comparisons and the study does not aim to profoundly understand them.

Empirical evidence of the study is gathered from a single case company, which is a large Finnish retailer that structured its internal control.

1.4 Theoretical framework

Internal control is a part of corporate governance and therefore relies on corporate governance theories. First and foremost internal control is about company control and ensuring of diligence within the company. The main underlying theories are therefore related to the separation of ownership and control, the most important of being the agent-principal theory, as described by Jensen and Meckling (1976). The principal-agent theory is one of the underlying rationales "*for how the public corporation could survive and prosper despite the self-interested proclivities of managers*" (Daily et al., 2003, pp. 371-372).

There are plenty of other theories complementing the agent-principal theory on the rationality of separating ownership and control, these include the resource dependence theory, which suggests that outside directors are the providers of needed resources for the company (Pfeffer & Salancik, 1978) and stewardship theory, which describes directors as frequently having parity of interest with those of shareholders (Davis et al., 1997). These complementing theories are however not explored further in the study as the basic motivation for internal control is already represented by the agent-principal theory.

Internal control is ultimately a corporate governance tool for the owners of the company which, when at an adequate level, ensures that shareholder value is secured and not wasted, stolen or misappropriated by the management. The need for internal control is emphasised as the size of the company and its number of owners grows. Good internal control ensures that the company is functioning according to the rules and objectives that should obligate it (Maijoor, 2000, pp. 104-105).

Internal control has caught the attention of researchers and other accounting professionals alike in the near past. The amount of literature published in the last 15 years on the subject is many times that published in the 1980s and 1990s. Main reasons for the grown interest in corporate governance and internal control are the several major accounting scandals of the 21st century and poor risk management practices (European financial crisis). These have in turn led to reforms of corporate governance legislation in several countries, Sarbanes-Oxley Act in the US being the most prominent of them all. As the United States' is still the world's largest and most important economic power, all major reforms are of interest, especially so in this case as the SOX Act is very strict and specific. Because the United States is the most important and influential single economy in the World, the results of the new SOX regulation are closely monitored all around the globe. Many companies also cross-list in US stock exchanges, which requires them to adhere to SOX, which effectively brings the US standards on foreign soil. Internal control developments in the United States are also reviewed shortly in the study.

There are currently no such universal international standards on corporate governance or internal control as, for example, International Financial Reporting Standards (IFRS) in accounting. IFRS are administered by a board consisting of international members and reporting according to the standards is widely required from listed companies. Instead, corporate governance and internal control requirements are primarily based on national legislation (including SOX in the United States). European listed companies are required to report according to a corporate governance code and to conform to the 'complain or explain' –principle. Development of a Pan-European corporate governance framework and the harmonisation of corporate governance in the European Union has also been in the talks (European Commission, 2011, p. 3-19).

Finnish account legislation does not explicitly recognise internal control, however the Finnish Corporate Governance Code for listed companies does. Obligations set out for internal control are fairly vague. There is very little research on the subject of internal control in Finland.

The COSO framework on internal control is currently the closest thing to a universal internal control framework, as it is widely used by public companies in the United States and even the Securities and Exchange Commission of the United States recommends its use (SEC, 2003). The framework focuses on internal control, not covering corporate governance as a broad concept.

1.5 Previous research

There are a fair bit of papers that have looked at corporate governance's and internal control's impact on agency problems such as Singh & Davidson (2003), Adams (1994) and Pagano & Roell (1998).

Most of recent research on internal control centralises on the Sarbanes-Oxley Act (SOX) in the United States, as SOX sets a very strict set of standards for internal control, internal audit and the disclosure of deficiencies in internal control. New requirements mean more costs, which is why the most researched matter on the subject is the increase of costs for companies. Much debated points-of-views include the impact of internal control on the cost of equity (lower cost due to better control or higher cost due to increase in internal bureaucracy, e.g. Zhang, 2007; Ogneva et al., 2007; Leuz, 2007) as well as the costs of audit (Hay et al., 2008, Hogan &

Wilkins, 2008) and SOX's implications on the return on investment (Gompers, 2003).

Other studies have centred on issues such as the improvement in the quality of financial information and transparency (for example Ashbaugh-Skaife et al., 2007, 2008; Ettredge et al., 2006; Shapiro & Matson, 2008; Cohen et al., 2010; Hoitash et al., 2008). The implementation of SOX by public non-US companies has also been used as a control in assessing the cost-benefit balance of more rigorous demands for internal control, e.g. Arping & Sautner (2013) and Litvak (2007). As the SOX Act requires companies to disclose certain internal control deficiencies there have been plenty of studies on the effects of such deficiency disclosures, for example Krishnan & Visvanathan (2007), Bedard & Graham (2011), Beneish et al. (2008), Ge & McVay (2005), Hammersley (2008), Johnstone (2011) etc.

There is internal control research and cost-benefit analyses of a more robust internal control regime (e.g. Arping & Sautner, 2013; Sarens & De Beelde, 2006; Hoitash et al., 2008), however there is hardly any literature on the structuring of internal control systems within a company.

1.6 Study methodology

Methodologically this study is qualitative. A qualitative study does not seek to test theories or hypotheses, instead its purpose is to examine the research object elaborately yet thoroughly. The collection of empirical data in a qualitative study is typically performed by observing the research objects in actual real-life situations, simultaneously acknowledging their views on the subject. Research strategy employed is case study, in which the points of interest often are processes that are studied in as natural a

state as possible. Case study is a fairly practical research approach and therefore suits well as a tool to lay groundwork for actual real-life operations. (Hirsjärvi et al. 2009, pp.134 -135, 164, 191 - 192)

The theoretical part of the study primarily refers to articles published in professional, peer-reviewed accounting journals. Other existing literature sources are also used, mainly books and electronic publications by professional organisations.

The gathering of empirical evidence was performed through interviews, observations and the defining of processes and controls in the case company. Other material utilized include existing documents produced in the case company.

The interviews were conducted in the case company as semi-structured interviews, where the themes and key points of the themes were presented to the interviewees and discussed in an open manner. Persons interviewed mostly consisted of the case company's personnel, primarily focusing in understanding the current status of internal control in the company. No recordings of the interviews or meetings were made, instead the key points were written down during the discussions.

The other primary data collecting method employed in the study is participant observation. Participant observation performed in the case company was free form and within a relatively long period of time (12 months), observations were made both without prior planning informally and in meetings. The method was used to form an overall picture of the company's control environment, key processes, risks and existing controls. The observations provided insight on the current state of the company's internal control.

1.7 Study structure

Structurally the study consists of four parts: introduction, theoretical part, empirical part and summary and findings. The theoretical part explores the underlying theories, regulation and recent history of internal control in Europe, the United States and Finland. The objective is to render a background against which the empiric part can be reflected.

The empirical part of the study concentrates on the practical internal control structuring process of the case company, starting from the definition of the internal control policy of the case company, continuing with the practical internal control structuring and ending up with a final assessment of the internal control status in the case company, findings and development needs.

Findings of the empirical part are reviewed and summarized in the final part of the study – the achievement of objectives and answers reached to the research questions are also outlined. Identified internal control development needs in the case company as well as implications for further research are also discussed in the final part of the study, followed by appendices.

2 Corporate governance and internal control

2.1 Control and efficiency - conflicting objectives?

Corporate efficiency is essentially associated with speed and profitability (lower cost or higher output), for example the introduction of airplanes permanently changed the efficacy of global travel, while the advent of the telegraph transformed the performance of communication both in speed and profitability. When considering the term control, or more specifically control activity, one can easily be seen contemplating security check queues at an airport before boarding or an accountant reconciling accounts upon monthly closing of the books. At first it seems obvious that one will always impede the other.

Considering the main purpose of internal control, protecting of shareholder value within the company, a security check at an airport or a reconciliation of books seems like a necessary evil from an efficiency point-of-view – it takes up resources and sometimes even frustrates all parties involved yet at the same time protects the interests of the company and sometimes even those of other parties involved. A more holistic view of control activities however quickly brings to light the benefits that the initial hindrance of control creates. Sufficient controls not only protect shareholder value but can also improve the quality of the actions controlled so, that they actually minimise effort in a later stage of a process. Take the example of monthly reconciliations: when sufficient reconciliations are performed monthly there should be considerably less work when preparing year-end financial statements than if such reconciliations were not performed on a monthly basis. The monthly control will drive behaviour towards self-correction, so there will not be a build-up of errors on year-end. The reconciliation then serves both control and efficiency.

The development of internal control therefore has positive value for the company, not only in securing of assets and other interests but in efficiency gains as well. An example from the world of internal audit, a study by Bou-Raad (2000, pp. 182-186) indicates that well-functioning internal audit and internal control can serve the needs of the company, helping the company in keeping up with the with the demands and competitiveness of the market – therefore serving the company and its management in actual business efforts by being involved in system design and structuring of internal controls. The key to the cost/efficiency optimum of internal control is in sufficient yet not excessive control and focusing of activities on correct issues, which yield positive net results.

2.2 Agent-principal problem

This separation of decision control and residual risk bearing is associated with the principal-agent problem. Agency costs and the share of ownership of managers correlate inversely, demonstrated in many studies. For example, Ang et al. (2000, pp. 92, 104) demonstrate that agency costs are higher when the company is managed by an outsider, at least in the case of a small business. Their study also indicates that agency costs increase with the number of non-manager shareholders. The correlation of managerial equity ownership and agency costs has also been demonstrated by Singh and Davidson (2003, p. 814), who find that higher inside ownership aligns managerial and shareholders' interests and lowers the agency costs in large corporations. A study by Denis et al. (1997, pp. 157-158) also indicates that the lack of ownership by managers may lead to ineffective resource spending decisions by the management (demonstrated with diversification in the study).

Agency costs have been explained by conflicts of interest: the interests of outside shareholders and managers with no ownership differ as the managers do not directly enjoy the wealth gains of success nor do they bear the costs of failure, both of which are primarily the plight and delight of owners. For this reason the market price outside shareholder pays for equity is lower than the price for which an owner-manager values the company according to Jensen & Meckling (1976, pp. 11-12). The difference, agency cost, reflects needed expenditure on monitoring and the effect of the divergence between managers' and owners' interests. The divergence of interests typically manifests as managers avoiding personal costs (i.e. minimizing effort) and trying to maximise their own utility. Pagano and Roell (1998, pp. 187-188; 215-216) demonstrate that widely dispersed ownership tends to further increase agency problems as minority shareholders may have conflicting goals, little possibility or simply no interest to monitor managers, whereas owners with larger stakes have greater incentive to secure their investment.

2.3 Corporate governance

In order to alleviate the principal-agent problem companies need corporate governance. Shleifer and Vishny (1997, p. 737) define corporate governance bluntly as "the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment". In other words corporate governance means all the mechanisms that secure the investors financial contribution to a company.

Corporate governance is therefore a broad concept. However the most crucial cog in the well-oiled machine that is corporate governance is an

effective and functioning board of directors. The shareholders of the company appoint a board of directors, whose objective is to enforce the fulfilment of shareholder interests by scrutinising the highest decision making within the company. The more investors the company has, the more important the board is. The board has the right to hire, fire and compensate the highest decision managers of the company as well as to ratify and monitor important decisions. According to Fama and Jensen (1983, pp. 310-312), exercising these rights helps to ensure the separation of decision management (initiation and implementation of decisions) and decision control (the ratification and monitoring of decisions). The importance of delegating the control of decision making is especially important in companies with widely dispersed ownership. Besides the board, incentives that reward the manager by his performance in adding to the value of the company (e.g. company shares or stock options) are one of the most effective tools in mitigating agency problems. Fama (1980, pp. 293-294) finds that competition between managers (within and outside the company) is also a mechanism that drives the managers to better performance.

Seeking better performance and alignment of interest of the owners and managers by ownership incentives can be a double edged sword, when the associated pay-off has the potential to make managers life changingly rich. According to Gordon (2002, pp. 1248 – 1249) if management stock option grants are very large and exercisable in the relatively near term, they can lead to a tendency in the management to seek maximal variation in the stock price to increase their own wealth. This can make excessive risk taking that threatens the company in the long run or even accounting fraud too irresistible for the managers. Boards do therefore form remuneration committees, audit committees and other oversight instances, many times at least partially manned with independent experts. Audit committees bear the ultimate responsibility for the reliability of the company’s financial reporting and internal control (Xie et al., 2003, p. 307).

However, in practice most board members do not partake in the day-to-day running of the company and rely solely on the image conjured by the acting management and annual audit reports, especially so if the board member represents a block of shareholders and has come from outside the company. According to Jensen (1993, pp. 40-43), many times it is the CEO who effectively defines what is communicated to the board by the management. It's in human nature that few people wish to present the results of their actions in negative light – a tendency that can lead to a situation where even vital information can be withheld from the board to avoid conflicts, particularly so if the CEO feels threatened or otherwise uncomfortable communicating the bad news. These omissions are much more likely to emerge as crises rather, whereas openly communicating at an early stage have a good chance to be tackled as met as solvable problems for which the board gives priority or merit so, that they would be communicated to the lower levels of company management and thereafter met by a continuously self-correcting mechanism.

The motivation for enhancing internal control is usually related to the company's financing as owners and stakeholders who are not part of the operative management of the company will want further mitigation of the uncertainty of their investment as the risk grows. Fundamentally there are two ways to amass new capital: either borrowing from financial institutions or attracting equity by finding new investors. Borrowing from financial institutions typically leaves the company's shareholder and governance structure relatively undisturbed. However as the amount borrowed and therefore the risk of the financial institutions' grow, they may want other guarantees, such as covenants, which can delimit decision making in the company (Xie et al., 2003, p. 307). Growing interest risks and high net debt ratios will also be discouraging points for further borrowing.

The growth aspirations of the company can crave so much equity that the only sensible solution for raising further capital will eventually be to go public. It is usually the most important decision that the company makes during its existence, effecting the company in a vast variety of ways. From an agent-principal problem point-of-view the influx of new equity and investors means further segregation of ownership and management in the company, as it is impossible for a wide base of shareholders to take part in the day-to-day management of the company. Simultaneously owner-managers' relative ownership decreases and/or they step aside from the day-to-day managing of the company. Both result in an increase of agency costs.

Law, stock exchange rules and other binding mechanisms counter some of the increase in agency costs, as the decision to go public forces the company to follow a higher set of standards concerning corporate governance issues and transparency, including internal control. The United States, the EU and Japan all oblige companies willing to go public to employ some form of internal control and internal audit functions or processes to reduce risks of misconduct.

Increase in corporate governance and internal control within a company should however not only be motivated by law. As the company grows so do monitoring problems: complex structure and multiple business operations mean more decentralization. Especially so if growth is achieved by mergers, acquisitions or by adding business segments. This added complexity and potential overlap makes it constantly harder for the board to be sure that the company is governed properly, working within legal boundaries as a whole and also in the interest of the owners, thus increasing agency costs and need for monitoring. As the agency theory suggests that the mitigation of agency problems lowers agency costs, good corporate governance can accordingly ease the procurement of capital. The company should therefore

have an incentive to improve its internal control whenever the upsides of the improvements outweigh the increase in monitoring costs. When the providers of capital have reasonable reassurance that their investment is protected and spent efficiently to maximize their returns, the cost of equity and borrowing should be lower for the company (for example Kim & Sorensen, 1986, pp. 140-142).

Classical competition theory suggests that in the long run product market competition will drive firms to minimize costs. Adopting of rules, including corporate governance mechanisms, would therefore be a part of this cost minimization, as it will enable them to raise capital at the lowest possible cost (for example Alchian, 1950, pp. 220-221). The company's internal level of corporate governance cannot however compensate for a poor rule of law or an inadequate corporate governance legislation. For example after the downfall of the Soviet Union, it was next to impossible for Russian companies to borrow money as there was practically no corporate governance and there no trust within the markets; the central bank even explicitly denied credits to new firms (Boycko et al., 1993, pp. 172-174, 186). The importance of a legal and institutional framework for the effectiveness of corporate governance is therefore paramount.

2.4 Recent internal control developments in the US

Internal control in the United States is currently strictest in the world and has a very formal approach to internal control, where non-compliance is not an option (comply-or-explain -principle effectively leaves the option not to comply in the EU). Developments in the US are closely watched and monitored by legislators around the world due to the influence of the US and its different approach in matters internal control.

There was a great deal of disagreement at the turn of the decade 1980-1990 on the quality of corporate governance mechanisms employed in the US, for example Romano (1993, pp. 1-5) suggested that as the United States corporate law was largely a matter of the states, not dictated by federal law, corporate law should have been a matter of competition between the states. According to the product market competition theory this should have then led to a level of regulation in corporate governance that would be optimal for both the company and investors, not forcing extraneous costs for either key participants, effectively mitigating material agency costs. Jensen (1989, pp. 67-68) meanwhile underlines the hefty premium (averaging 50 % above market price) that was paid in leveraged buyouts and takeovers, which illustrates the value public-company managers can destroy before they face a serious threat of disturbance. Jensen also stressed the need for internal control in companies that have no little outside forces to steer for good corporate governance: they dominate their product markets, have low debt ratios and enough self-financing not to be notably controlled by lenders. (Jensen, 1989, pp. 73-74)

There were hardly any major accounting scandals during the 1990's in the US as economy was booming. The turn of the century however triggered a series of bankruptcies that changed the landscape of corporate governance in the United States. Coffee (2005, pp. 1-2) suggests that accounting scandals typically surface as bubbles burst, which is exactly what happened in the early 2000's when the IT bubble burst. The most notorious of the failures in the US were those of Enron 2001, Worldcom 2002 and Tyco 2002. The public outcry that resulted from these consecutive major accounting scandals in the beginning of the 21st century was met with tightening of corporate governance norms and transparency requirements in the United States, as the *Sarbanes-Oxley Act* (SOX) was enacted in 2002, surprisingly quickly, as Brickey points out (2003, p. 2).

The downfall of Enron and Arthur Andersen became the very symbol of 21st century US accounting fraud and corporate greed due to their massive scale and the two companies' willingness to risk everything for financial gain. The incident served also a wake-up call for the tightening of corporate governance requirements in the USA, as the law is in many respects a mirror image of Enron's perceived shortcomings, addressing the board's management supervision and monitoring problems, identifying conflicts of interest as the root cause for such problems according to Deakin and Konzelmann (2003, pp. 1; 13). The Act also enhances criminal fraud penalties in the hope that it would deter personnel from engaging in such activities (Brickey, 2003, pp. 19-22).

The Sarbanes-Oxley Act was first and foremost enacted in order to calm down the public and the stock market, tightening requirements concerning corporate governance, ethics and transparency. The Act is arguably the strictest legislation in the world regarding the disclosure of information on internal control, corporate governance compliance and overall mandatory oversight of publicly traded companies. Internal control requirements in Section 404 of the Act has been at the heart of the SOX controversy due to its specific nature which corporate world feels is overly laborious and expensive to fulfil when compared with perceived gains. In 2003, the Securities Exchange Commission of the United States (SEC, 2003) published the final ruling on implementing Section 404, which has been consequently in effect from the year 2004.

Section 404 dictates that a variety of issues on financial reporting internal control and risk management that need to be periodically addressed, reported, reviewed and auditor attested. Directly related, section 302 requires among other things that management disclose any significant internal control deficiencies when certifying annual or quarterly financial

statements (Zhang et al., 2007, pp. 302 – 304; SEC, 2002; SEC, 2003). Internal control reporting in the pre-SOX era was not compulsory, which is arguably the primary reason internal control was ineffective in uncovering malfeasance in the early 2000's accounting scandals. The SOX Act now sets vastly higher standards on corporate transparency and control. Shapiro and Matson (2008, pp. 222-225) assert that the situation is better post-SOX, but also say that the Act will fail to achieve its full potential and risk turning into symbolic theatre if there is not enough resources to properly monitor and enforce the new requirements by the authorities.

The new standards require more work, which translates as increase in direct costs, as for example Arping and Sautner (2013, pp. 1133-1136) point out. According to their study the new requirement of internal control assessments from both management and independent auditors result higher mandatory control costs. The initial impact for a majority of companies that the Sections 404 and 302 concern seems to be an increase in direct monitoring costs. Most companies view these costs as superfluous, while there are also ardent proponents of the new tighter internal control regime. This has only naturally sparked a wide spectrum of controversy over the balance of benefits and costs resulting from the increase in regulation.

Market liberals have been making most noise against the new regulations, claiming the law to be too hastily drafted and being too costly when compared with the benefits. There seems to be a sentiment among the opponents of the law that product market competition will do a better job of enhancing corporate governance than regulation - some are even calling for the repeal of the Act. For example concerning the requirement to disclose internal control weaknesses, Ogneva et al. (2007, pp. 1255-1258) argue that companies which have reported internal control weaknesses have not paid significantly higher price for equity, even in the most egregious of cases. Representing a starker view, Romano (2005, pp. 9-12; 215-216)

implies that SOX is a purely bureaucratic exercise and completely alienated from real-life business, as the new demands leave companies very little leeway, unnecessarily imposing excessive extraneous costs. According to her, the Act should be repealed and that other countries should see SOX as a warning example of over-regulation. A less stark view, Ribstein (2002, p. 68-69) suggests that SOX could not have prevented Enron or the like as even back then existing regulatory framework was breached and the culprits were determined to ignore the risks of their actions. Ribstein implies that “promoting more independent monitors with lower-powered incentives to scrutinize the actions of highly informed and motivated insiders cannot solve this problem” and as at the time the SOX Act was just enacted and its implications were not apparent he asserted that the costs of increased regulation could be “significant”.

Proponents of the new regulatory regime defend the strict requirements by underlining the improvements in transparency, accountability and comparability of companies. The pro-side also argues that the regulation does not impose irrelevant expenditure on companies, instead it has value for the company and its stakeholders. For example Leuz (2007, p.147) has demonstrated in his study that the new legislation does not impose significant new net expenditure on companies that are well governed to begin with. A study by Ashbaugh-Skaife et al. (2008, pp. 247-248) concentrated on the quality of reporting accruals by comparing companies with SOX defined “internal control deficiencies” to those without. Their study suggests that ICDs have significant impact on the accrual quality of the companies as companies that reported ICDs had larger abnormal accruals and greater noise in their accrual reporting, indicating a better level of quality in financial reporting by companies that had been deemed to have sufficient internal controls by their management and auditors.

The price of non-compliance and poor corporate governance can be very high. In January 2004 Adecco, a Switzerland-based company providing HR-solutions, hit the headlines as auditors refused to sign off on their 2003 accounts, citing “material weaknesses in internal controls in its North American operations”. Investigation of the matter led to the loss of reputation and ruined the company’s market capitalization. Direct cost to the company was over 100 million USD and took over 160 000 hours of forensic accounting work. Irony of the investigation results was that no material accounting irregularities were found. The company’s internal controls were merely so poor in certain areas that the auditors refused to sign off on the financial statements (Renes, 2008, p.4). The auditor reaction was a direct consequence of tighter corporate governance rules, primarily SOX sections 302 and 404 which require the company’s management and auditor to certify that the company’s internal control is adequate as well as disclose any internal control weaknesses upon releasing annual and quarterly financial statements. SOX had been in effect for only two years at the time while Section 404 had just come to force. It can be then assumed that Adecco had not reacted adequately to the new regulations, apparently assuming that the ambiguous assessments of internal control previously accepted would suffice, with expensive consequences.

2.5 Recent internal control developments in the European Union

From the beginning of the 21st century the EU has sought to reform and unify corporate governance and internal control within the Union. The bottom line for internal control requirements in the European Union is therefore laid down by EU directives that obligate all member states of the

Union. Internal control regulation may be stricter at national level (this is not the case in Finland), yet the minimum requirements are set by the EU.

Europe has not been spared of massive accounting and internal control scandals in the 21st century either, yet the scandals have been milder than in the US. Most notable cases being of the Dutch retailer Ahold (2003, although irregularities concerned primarily US subsidiaries), Anglo Irish Bank (2008) and Vivendi (2002), which involve corporate governance breaches and complex accounting schemes that were not illegal *per se* but hinder transparency. The biggest and most prominent is still of course the scandal of the dairy giant Parmalat in 2003, where the company admitted to inflating billions in revenues. Also called “Europe’s Enron”, the scandal further attributed to the development of a universal European corporate governance framework. Preparative work on the framework had already begun in the wake of Enron in the US, and, according to the Global Corporate Governance Forum’s paper (2008, p.3), the current European debate on corporate governance began with the 2002 report concerning corporate governance and company law modernisation, published by the European High Level Group of Company Law Experts. Consequently, in 2003 the European Commission outlined an action plan for modernising company law and corporate governance in the EU (Global Corporate Governance Forum, 2008, p. 4-5).

The action plan led to the adoption of a distinctly European corporate governance approach, the ‘comply-or-explain’ –principle, first coined in the UK after the Cadbury report of 1992 (Arcot et al., 2010, p. 194). Formally introduced in the EU Directive 2006/46/EC Article 46a on 14th of June 2006, the Directive requires a listed company in the EU to annually issue a corporate governance statement in which it must include a description of the main features of any existing risk management systems and internal controls in relation to the financial reporting process as well as declare the

national corporate governance code that it adheres to. The Directive however leaves flexibility, as the company need not adhere with all the recommendations of the corporate governance code, but only with recommendations relevant to its business (The Parliament and Council of the European Union, 2006).

This is called the ‘comply or explain’ –principle, which effectively means that even though a company listed in a stock exchange within the EU is required to follow a corporate governance code, they are allowed to divert from the code if they provide an explanation for the divergence in their corporate governance statement. The ‘comply-or-explain’ -approach is therefore rather more autonomous and self-regulative than SOX. It primarily relies on investors to monitor and enforce corporate governance codes, while the EU obliges market monitors only to verify if a corporate governance statement has been published – although market monitors in some EU countries also analyse the substance of the statements.

The principle has enjoyed a wide acceptance in both the corporate world and among institutional investors due to its flexibility, which better accommodates the needs of smaller businesses and makes going public a more intriguing option when the perceived costs of fulfilling the corporate governance requirements are lower than a complicated and mandatory ‘one-size-fits-all’ –approach, such as that of SOX. Even the European Corporate Governance Forum has issued a statement on internal control on which it comments on the very strict internal control requirements of the SOX Act and implementation costs for companies associated with the Act. The Forum raises concerns over the possible counter-productivity of strict internal control requirements, stating that the actual purpose of internal control is to manage the risks associated with the successful conduct of business, not to eliminate them (European Corporate Governance Forum, 2006, p. 2). However as the principle leaves the ultimate monitoring

responsibility to the company, questions have been voiced especially by the academic community whether or not the principle risks rendering corporate governance ineffective within the EU.

Scarabotti (2009, pp. 77-79) for example has questioned whether the principle is a valid safeguard for corporate governance in a case such as the Parmalat incident and how to overcome differences in national enforcement of the principle. The shadow of doubt is also cast by Andres and Theissen (2008, p. 300), whose findings imply that as the ‘comply-or-explain’ -principle relies on investors monitoring the quality of corporate governance and the quality of information disclosed, managers can effectively decide not to commit themselves to transparency requirements if the ownership structure and the accompanying monitoring incentives give them the freedom to do so. Other research on the effectiveness and validity of the ‘comply-or-explain’ approach include studies such as Van De Poel & Vanstraelen (2011), Seidl et al. (2013), Keay (2014) and Nedelchev (2013).

Good corporate governance practices lead to transparency and to a level of trust and liquidity in the capital markets, which support earnings and investment. The European Commission has responded to the concerns of overly lenient corporate governance in the European Union by contracting a study on the matter in 2009. The study further confirms academic findings, as it is established in the study that the explanations provided by companies departing from corporate governance codes’ recommendations are mostly not of a satisfactory quality (Risk Metrics Group, 2009, pp. 188). It is also suggested in the study that enhancing the role of market-wide monitors in enforcing a meaningful ‘comply-or-explain’ -principle should be considered by such means as review of the veracity of the statement content via cross-checks with other publicly disclosed documents, as well as an assessment of the informative value of company corporate governance statements (Risk Metrics Group, 2009, pp. 179-180). In spite of its shortfalls, the study implies

that the ‘comply or explain’ –principle should not be abandoned, instead its enforcement and monitoring should be further developed and introducing a reporting framework should be considered.

The European debt crisis, which began 2009 in the wake of the global financial crisis, also painstakingly revealed problems in banking world corporate governance. Too little safeguarding measures and corporate governance requirements on banks combined with incentive schemes within banks that encouraged risk taking, provided ample and cheap credit accordingly between 2002 and 2008, when credit conditions were easy. This reckless lending led to a massive accumulation of bad loans in banks “too big to fail”. After the bubble burst in 2009 several of the banks had to be bailed out so that the weakest of the European economies would not collapse (arguably a chain reaction would have dragged the whole continent into economic chaos, would nothing have been done). Bailing out of course meant going for the tax payers’ pockets, breeding dissatisfaction (Molyneux, 2016, pp. 70 – 73).

As a result, the corporate governance demands on financial institutions were tightened. Consequently the European Commission also set out to assess whether there is a need to further strengthen and unify corporate governance requirements within the EU, stating in a 2011 green paper on European corporate governance framework that “it is of paramount importance that European businesses demonstrate the utmost responsibility not only towards their employees and shareholders but also towards society at large”. The Green Paper also refers to the 2009 study contracted by the Commission and suggests further monitoring of corporate governance codes when a company departs from a corporate governance code (European Commission, 2011, p. 3-19).

The green paper has so far not led to a binding Pan-European corporate governance code let alone internal control reporting framework, as a majority of the responses to the green paper underlined the diversity of company law across EU member states and problems that would arise from universal, rigid corporate governance models. Instead the European Commission published a recommendation on the quality of corporate governance reporting to address the highly variable quality of the explanations. The recommendation suggests companies that diverge from their applicable codes should state which parts they have diverged from and why, how the decision to diverge was taken, and also say in what manner the company has diverged (European Commission, 2014). On the whole, however, Europe's current self-regulative stance on corporate governance seems to prevail, in which only certain aspects are harmonised with EU directives, mainly concerning disclosure of information in listed companies and financial institutions. Otherwise EU-level direction on corporate governance is primarily done by recommendations, as the Commission's official web page on civil justice lets on (European Commission, 2016).

Market regulation is always a tightrope, as over-regulation tends to lead to counterproductive results. Currently the SOX-approach of the US represents a highly regulated model while the EU is exploring the more lenient 'comply-or-explain' –approach. Litvak (2007, pp. 215-226) for example has been researching the effects of corporate governance regulation by analysing company market valuing. The author examines the effect of strict US corporate governance regime with other national regimes by analysing stock prices of companies that are listed both in the US and abroad. Results indicate that the obligation to conform to SOX actually seems to have adverse effects on the stock prices of European companies, implying that the market does not believe SOX will add any value to companies governed by European standards, quite the opposite. These results would suggest that a SOX-type approach would not serve as value-

adding regulation in Europe – primarily meaning the most expensive and laborious part of SOX, which is the requirements concerning internal control in Sections 404 and 302.

There is still room for improvement as new scandals keep popping up: there was the corporate governance and accounting scandal of the Spanish fishing giant Pescanova in 2013, when in 2014 the UK retailer Tesco overstated its revenue due to aggressive accounting. The emission scandal of German automaker colossus Volkswagen in 2015 was also a corporate governance scandal in a broader sense. Certain is however that not all crises and scandals can be averted with increased regulation. It is highly likely that some of the larger European scandals of the recent years would have happened even if the European Union had decided to take steps towards a more SOX-like approach of corporate governance and internal control.

2.6 Corporate governance and internal control in Finland

In Finland the local legislation does not directly refer to internal control requirements. Instead, some internal control topics are indirectly regulated in accounting legislation, i.e. accounting law, securities market law, audit law, limited liability company law. These indirect rules pertain to the disclosure of information, auditing and corporate governance. Requirements on non-listed companies are fairly loose, probably due to the fact that non-listed company ownership in Finland is typically European; concentrated on the hands of only a small amount of shareholders, which means smaller agency problems and therefore smaller need for internal control, internal control therefore not a major issue.

According to section 11:28 of the Finnish Securities Market Act, a listed company must directly or indirectly belong to an independent organ that widely represents business life, is established in Finland and which has issued recommendations on the actions of the management of the target company in a takeover bid in order to promote good securities market practice. In practice this means that a company listed in the Helsinki OMX has to be a member of the Securities Market Association of Finland. The Association administers the Finnish Corporate Governance Code, which sets various corporate governance standards for publicly traded companies in Finland. Compliance of the code is required from the members of the Association. The Security Market Association is currently *de facto* the only instance that fulfils the requirements of the law (Confederation of Finnish Industries (EK), 2016).

The Finnish Corporate Governance Code includes recommendations on internal control, internal audit and risk management among other things. Some of the recommendations are based on statutory demands on listed companies, being therefore non-negotiable. Besides these law-mandated requirements, however, in order to adhere the code it is not compulsory for the company to comply with all of the recommendations. According to the EU Directive 2006/46/EC, a listed company must either comply with the recommendation or explain why it doesn't ('comply or explain' -principle). Explaining instead of complying may negatively affect the share price of the company or even make the company ineligible to list in the OMX Helsinki stock exchange. (Securities Market Association of Finland, 2010, pp. 17, 24)

The Code has fairly little requirements concerning internal control. It requires companies listed in the NASDAQ OMX Helsinki stock exchange to provide an annual corporate governance statement, on which the company is to explain its internal control principles in relation to its financial reporting.

The company is also required to have some form of internal audit to verify the effectiveness of its internal control, however the Code or the EU regulations do not require the disclosure of any internal control deficiencies detected, contrary to SOX requirements in the United States. Furthermore, the Code requires the company to have an audit committee, which must include in its duties the monitoring of the efficiency of the company's internal control and risk management systems as well as the reviewing of the description of the main features of the internal control and risk management systems in relation to the financial reporting process. The company must also issue annually a corporate governance statement, in which it must include a description of the main features of the internal control and risk management systems in relation to the financial reporting process.

The Finnish Corporate Governance Code then does not give an explicit set of requirements or specify a standard model for reporting and defining internal control or audit. This is in line with the current EU approach to internal control, which employs no strict standards or models. The Finnish Corporate Governance Code as a whole only outlines the questions that a listed company must address, leaving wiggle-room and flexibility for businesses of different character and scale. This is a much more *laissez-faire* approach than in the United States, where the SOX has a far more dictating, top-down approach to internal control and audit reporting with little room to manoeuver.

2.7 COSO framework

Historically there have been fairly little statutory demands on internal control both in Europe and in the US. The SOX was a major step in the direction of highly regulated and comparable internal control systems in the United

States. The framework by the United States based Committee of Sponsoring Organizations of the Treadway Commission (COSO) for internal control has since become a *de facto* standard for defining and implementing internal control systems. COSO was formed in 1985 to sponsor the United States National Commission on Fraudulent Financial Reporting by five major US professional accounting associations. The COSO Internal Control Integrated Framework was first released in 1992, the latest incarnation being from the year 2013. According to Sarens and De Beelde (2006, p. 70), the COSO framework is most widely used internal control in the US as its utilization is strongly recommended by the SOX Act.

The COSO framework defines internal control as a process, which is affected by personnel at every level of the organisation, not only by the board and management. The main goal of internal control is to provide reasonable assurance regarding the achievement of the company's objectives in (COSO, 2013):

1. efficiency of operations
2. securing of assets
3. reliability of financial reporting
4. compliance with laws and regulations.

The framework consists of five components (COSO, 2013):

1. control environment
2. risk assessment
3. control activities
4. information and communication
5. monitoring

Component	Key concepts
Control Environment	1. Exhibiting commitment to honesty and ethical principles. 2. Define structures, responsibilities and duties 3. Corroborating each employees duty to control 4. Commitment to competence 5. Assuring the monitoring of responsibilities
Risk Assessment	6. Defining objectives 7. Identifying and analysing risks 8. Assessing risks of misconduct 9. Identifying and analysing significant changes
Control Activities	10. Choosing and developing controls 11. Choosing and developing general system-based controls 12. Putting controls to practice by means of instructing
Information and communication	13. Using appropriate information 14. Communicating internally 15. Communicating externally
Monitoring Activities	16. Performing continuous or separate appraisals 17. Assessing and communicating deficiencies

Figure 1, The COSO internal control integrated framework (COSO, 2013)

The status of the framework as an internal control authority is indisputable in the United States, where most companies state their internal control is defined in accordance to the COSO framework, main reason being that companies can fulfil the strict requirements of US internal control legislation by adhering to the COSO framework - even the SEC endorses the use of COSO (SEC, 2003). There has naturally been critique of the COSO framework. Critics are saying that the framework is too complex and too embraces too broad a scope (e. g. Romano, 2005; Ribstein, 2002). This can lead to needlessly heavyset internal control systems, in which expenses can outweigh benefits.

The key to a meaningful internal control system is the balance between input and output. Controlling must not become self-serving, instead it must settle at a level that optimally protects shareholder value without hindering productivity and day-to-day business activities. In an ideal situation internal control function is an asset within the company, unifying practices, finding synergies across company departments and providing important feedback

on process bottlenecks, helping find new sources of efficiency. Internal control and internal audit should also serve as an important source of information for the senior management on emerging operational risks.

The point is, that beyond a certain level control can be counterproductive. For example, theft is a massive problem for the retail industry, eating away at shareholder value. Thievery can be virtually eliminated by locking up all items in electronically monitored cabinets, from which items are taken out only against payment or for salesperson-monitored viewing by the customer (as a typical consumer store was modelled in the former Soviet Union). This hypothetical model would lead to a close-zero theft shrinkage thus protecting shareholder value, but growth in monitoring costs and the amount sales lost would far outweigh the gains of lower shrinkage. Excessive control in the made up example would lead to much larger losses of shareholder value than a more conservative level of control. Measures to secure shareholder value should be implemented only up to the point where they don’t cause costs and hinder revenue generation (i.e. sales) more than they secure shareholder value.

3 Structuring internal control in a case company

This section of the study concentrates on the definition and structuring of internal control in the case company. The chapter begins with the portrayal of the research method and material used. The introduction of the case company and the motivations and objectives behind the case company's internal control structuring project are then described in a separate section following the introduction, this is followed by the description of the process of internal control structuring project in the case company and finally by the results of the case study.

3.1 Research method and empirical material

As a process the empirical part of the study was conducted according to the following scheme (Figure 2).

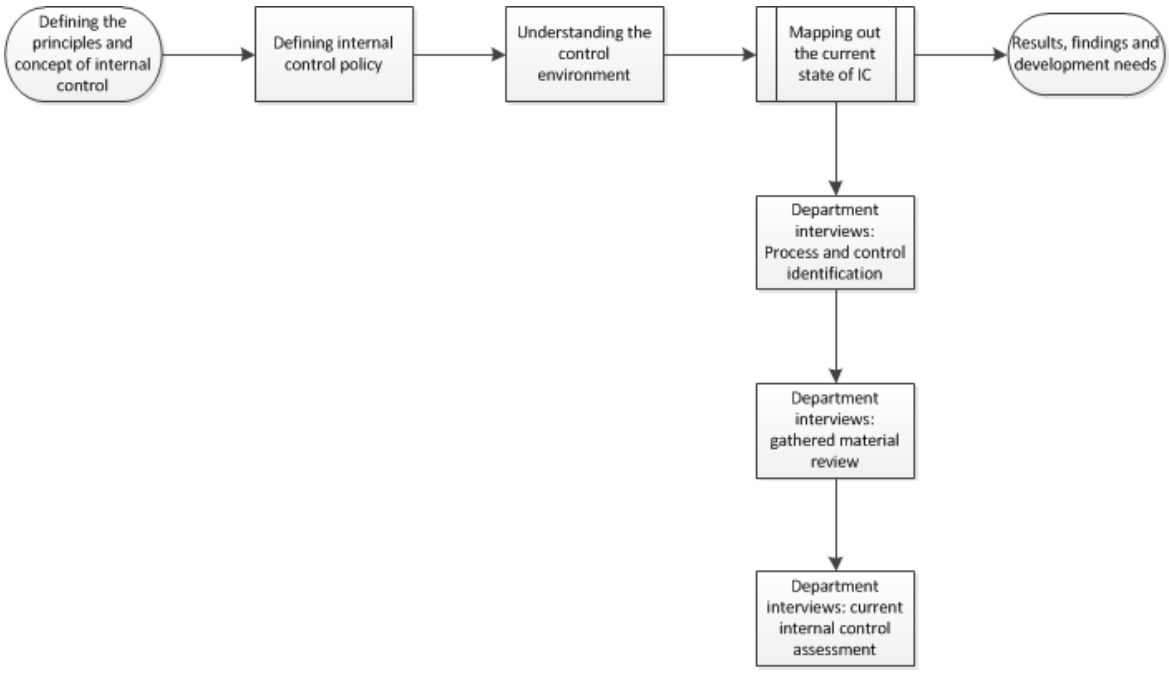

Figure 2, study empiric process

Methods chosen for the gathering of empirical information were interviews and participant observation due to the nature of the project. The interviews were conducted as open and semi-structured interviews to leave room for discussion and to make possible for the subjects to bring up topics possibly not considered prior to the interview. The major advantage of open interviews is its' flexibility when compared to structured questionnaires, for example. Data gathering by interviews can be time consuming, but it also tends to help in making the interviewees active parties of the process.

Interviews can be used to find out how the subjects experience the world around them. However as these accounts are merely subjective views, it is preferable to utilize participant observing as an additional method to actually understand what is happening. Observing provides direct information and understanding on the research objects actions or behaviour, such objects can be persons or organisations, for example. The difficulty of observing is in taking the role of the observer, which entails being adequately present so that the research objects do not alter their behaviour and yet there is a risk that the observer's objectivity can deteriorate if he or she gets overly involved in the organisation. (Hirsjärvi et al. 2009, pp. 204 - 209, 212 - 217) A total of 39 interviews were conducted, most of which were group interviews. The interviewed personnel were middle management, directors or other personnel, who were responsible for their department's key processes and control activities. The interviews can be categorised in three archetypes, all of which were held with each of the departments, see Table 1 on the next page.

Table 1, interview types.

Interview name	Interview type	Description	Purpose of interview	Next step	No. of interviews (per dept)	Interviewees
Process and control identification	Semi-structured, open	Responsible personnel of each department interviewed on the department's key processes and controls. Data gathered was quantified and saved in uniform format (matrices, process diagrams).	Gather data to understand the internal control environment of the department.	Forming of the department's internal control structure.	1 - 4	Department middle management and key personnel.
Gathered material review	Semi-structured	The department's internal control structure, that was compiled from the earlier interviews, was reviewed and confirmed with the department's key personnel.	Getting confirmation that the internal control structure formed is correctly formed (all relevant processes and controls were identified).	Assessing the current state of the department's internal control, identifying weaknesses and development needs.	1	Same as interview 1. Some interviews were substituted with email correspondence.
Current internal control assessment	Semi-structured	The assessment over the current state of internal control in the department based on material gathered earlier was gone through with the department key personnel.	Reviewing the assessment on the current state of internal control in the department with key personnel. Communicating identified deficiencies.	Creating a schedule to remediate the identified deficiencies.	1	Department middle management, key personnel and directors.

Purpose of the first round of interviews was to understand the current state of internal control in the company by interviewing parties responsible for crucial processes. This information was used to structure the departments' internal control. The validity of the structuring was confirmed in a separate meeting with the department's representatives. Subsequently an assessment of the department's internal control status was made and reviewed together with the department in a third meeting. A complete list of the personnel and date of interviews that were undertaken during the process can be observed from appendix 1 of the study (*table of interviews)*.

The study coincided with the case company's project of internal control definition. This essentially relates to the understanding and mapping out of processes and controls within the company. As some process diagrams, work instructions, control descriptions and other material produced prior to the project already existed, there was no need to produce everything from scratch. Instead updating and supplementing existing material sufficed in some instances, whereas other processes had not been described at all and therefore required information gathering and defining. The interviews, observations and existing material gathered were utilized to produce process diagrams and descriptions and the mapping out of controlling actions.

Key processes and controls were identified throughout the organisation based on the interviews conducted as well as on existing material. The process defining was carried out from a department point of view, meaning that interviews and materials were grouped by the departments responsible. After the initial outlining of processes, a map of processes was drawn for each of the departments and process levels identified. Most departments' definitions were structured as a two level hierarchy, however some of the departments' descriptions include only one level of processes to retain a

meaningful level of relevance in the process diagrams and to avoid “the defining of processes only for the sake of defining”.

The key controls were quantified by cataloguing them in “control matrices”. These matrices were uniform, containing information of the pertaining process and responsible persons. The adequacy of the controls was assessed in the matrix and given a score from 3 to 1, where 3 indicates a very good level of control and 1 the opposite. Identified control deficiencies were also defined in the matrix, with a score of 0. An example of the matrix available in appendix 2 *(department control matrix example)*.

The processes were categorised into a three-level hierarchy, from highest to lowest: company level, function level and sub-function level. The company level was effectively the “big picture” of processes and a list of the departments in the company (ten departments). The second level, function level, was a list of the department’s main processes, produced for each department separately. This was also meant to serve as a tool for the department in understanding its own functions. Processes of the highest two levels were then assessed and given a grade in two attributes concerning internal control. These attributes were:

a) gravity of possible internal control risks associated with the process (*internal control importance*)
b) current state of internal control (*internal control status*).

In order to be comparable and to retain the effort-benefit balance of control, each of the department’s processes was categorised from A to E by the significance and risk potential for the company that was associated with the process. The baseline for the categorisation of the risk and importance of processes was uniform, the framework used was the same as in the company’s risk management process (see appendix 3, *risk assessment matrix*). The assessments focused primarily on the potential monetary

losses should the process break down, also minding other internal control objectives such as the quality of accounting information, that were not present in the risk assessment matrix loaned from the company's ERM-process (enterprise risk management). If the score given was A, the process was critical for the whole company or carried with it a potential risk for very high losses. If the process had a mark of E, it was considered to be low risk and insignificant from a company-level internal control point-of-view. This score was called "internal control importance".

The processes were then also scored based on the current status of internal control activities related to the process. The assessments on the current status of internal control were made in respect to a perceived "optimal level of control". This is effectively a subjective assessment, as it is impossible to define a universal control optimum due to the qualitative nature of the processes and the amount of control. The underlying philosophy was, however, that the amount of control and the structure of the process and quality of the process definition should be in line with the magnitude of the underlying risk. Internal control input-output objective was therefore defined to be a function of secured shareholder value and costs of internal control, as in the following figure (Figure 3):

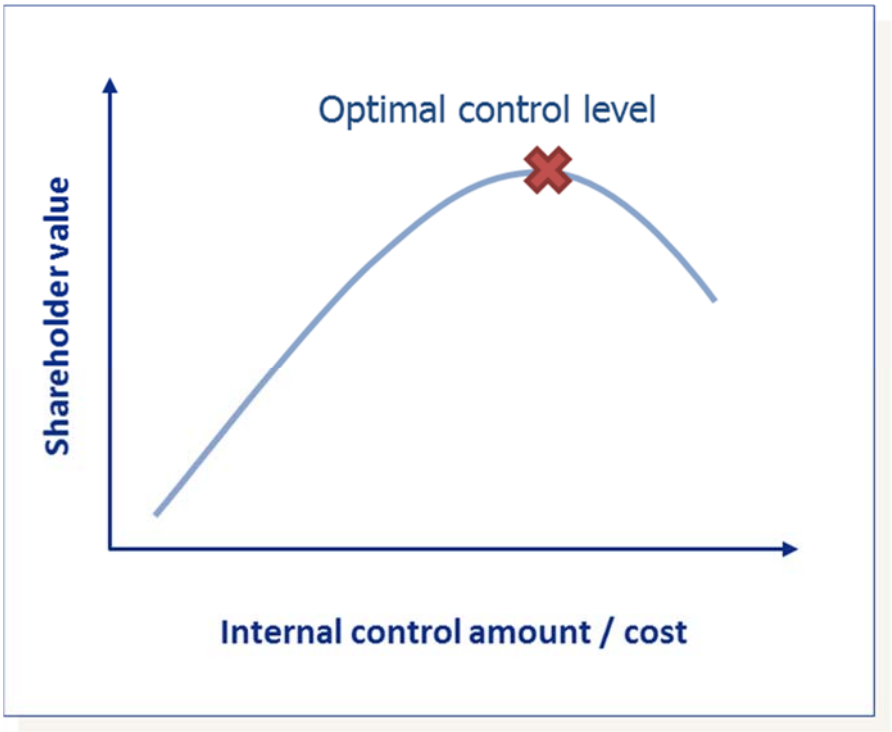

Figure 3, cost/benefit optimum of internal control within the case company

The assessment on the internal control status was based on material and information gathered during the interviews, primarily the process definitions and the key control matrix. All controls in the control matrix were considered and scores for the internal control of the processes were given out from A to F, where A meant that the process was well defined and understood and had sufficient controls. F on the other end of the scale meant that the process definition and controls were either non-existent or unacceptable. This score was called “internal control status”.

Both of the grades described above were well informed but still subjective assessments. A combination of the two grades was used to determine the significance of each process and ultimately the significance of the department in the context of the whole company’s internal control.

Processes were defined as either graphical process diagrams, in writing or both. The manner of description was chosen according to the nature of the

process, possible existing material and potential internal control risks. Less effort was allocated to the description of processes that were deemed irrelevant from internal control point of view.

In order to properly define the control environment of the company, all relevant company level policies, decision making structures and other steering documentation were also catalogued or documented.

3.2 Introduction of the case company

Founded in the 1980's, the case company is a large and relatively fast growing Finnish retailer. Being a typical retailer, the company does not engage in any manufacturing itself. Instead it focuses in its core competencies: it procures goods and sells them to consumers for a profit through its network of stores and an online store.

The company had no existing internal control structure per se, instead each department director was responsible for internal control within his/her area of responsibility. The identification of departments and their role in the company was therefore the first thing to do. Using the organisational chart as a basis, ten separate functions were identified and categorised as main functions and supporting functions as follows:

Main functions

1. Purchasing
2. Logistics
3. Store operations
4. Accounting and administration

Supporting functions

5. New stores
6. IT
7. Marketing
8. HR
9. Supply chain control
10. Safety and property

All supporting functions are concentrated in the company's distribution centre to maximize efficiency. Store operations concentrate purely on selling and maintaining of facilities and stock, store processes do not therefore include any invoicing, purchasing or other non-essential functions, which are instead produced by the service and administration centre. The extent of outsourcing in the company is limited to only a few very limited services, IT helpdesk and a part of fixed asset accounting.

The case company engages itself in the importing of sellable goods, with the aim to further expand own imports. For this reason the company has also founded a sourcing office in China (separate legal entity). However most of products sold by the case company are sourced from domestic suppliers or importers. The range of products offered by the company is very wide, spanning from groceries to motor boats. The company employs a large variety of private labels and as it is in many instances the sole importer of the products it also carries obligations typically associated with manufacturers according to the Finnish law.

The company has established stores in over 100 locations, but geographically operates only in Finland. The company can be categorised as a large company as the average number of employees was over 3 000 and total sales over 700 M€ in financial year 2014.

Ownership structure of the company is very concentrated as the biggest shareholder controls 83 % of shares and the second biggest 11 %, the major owners are legal entities and not actively partaking in the operative management of the company. The company management owns the remaining 6 % of the shares. Management ownership is the result of a management commitment scheme, in which the acting management has had the possibility to enter in to an agreement which entitles one to buy company shares for a discounted price. The scheme extends from senior to middle management.

3.3 Internal control structuring project of the case company

3.3.1. Defining internal control objectives

The case company set out to structure and define its internal control in a 2014 project. Main purpose of the project was to define internal control principles, create structures and processes to ensure that the company's internal controls are effective and sufficient to manage significant risks. A key aspect was to fulfil the requirements for publicly traded companies, laid down in the Finnish Corporate Governance Code. The board's primary means of monitoring control deficiencies before the project were limited on statutory audit reports and information communicated by the senior management. At the time of the project the company's ownership was fairly centralized with two major outside-owners – concentrated ownership means lower agency costs, as demonstrated by Pagano and Roell (1998). The case company has sought to further mitigate agency costs by aligning the managements' interests with the owners' interests by engaging the acting management with company share ownership (about 6 %), as described in the study by Singh and Davidson (2003), for example. However the company sought to fulfil the requirements of a public company – the

decision to go public would most likely result in a wider dispersion of ownership and therefore rising agency costs, which functioning internal control helps to mitigate.

The case company's primary objectives for internal control structuring were outlined in a kick-off meeting with internal control management consultants and the CFO of the company as follows:

- defining the control environment of the company and mapping out of its key processes and control activities
- creating reporting practices to provide the board of directors as well as the company management up-to-date information on the state of the company's control and governance situation
- identifying of significant internal control risks and ensuring their effective mitigation
- identifying of any material control deficiencies and monitoring the resolving of identified deficiencies
- complying with the Finnish Corporate Governance Code's demands on internal control.

The requirements on internal control, risk management and internal audit are laid down in recommendations 48 – 50 and 54 of the Finnish Corporate Governance Code. Internal control requirements are fairly lax, as the recommendation 48 of the Code stipulates: "the company shall define the operating principles of internal control", further elaborating: "the board ensures that the company has defined the operating principles of internal control and monitors the function of such control". In effect, the Code does not strictly require the use of a framework or extensively lay down the bare minimum that a company must do in order to comply with the recommendation. (Securities Market Association of Finland, 2010, pp. 22, 25)

Company-level risk assessment and management practices had been defined in an earlier effort, which is why the highest level of risk assessment was excluded from the scope of the company's internal control structuring project, because risk assessment is a key feature of internal control, as described in the COSO Integrated Internal Control Framework, for example (COSO, 2013). The Finnish Corporate Governance Code also requires the company to define its internal audit practices. This was recognised as a crucial component in verifying the adequacy of internal control, but also seen as a separate concept. The definition of internal audit principles and practices was also excluded from the case company's project and left to be covered in a separate project.

The case company opted to use the COSO Internal Control Integrated Framework as a base for defining its internal control system. After considerations and suggestions by the management consultants providing assistance in the kick-off it was decided, however, that the framework should not be slavishly applied, instead it would serve as a reference according to which the company's internal control would be modelled. This was due to the fact that COSO Framework is fairly intricate at times, as its main purpose is compliance with SOX of the United States (Sarens & DeBeelde, 2006). The intent was therefore to cherry-pick the best elements and either leave out or streamline the parts of the framework that were deemed as overly laborious considering estimated benefits.

A well-functioning internal control system was seen to have the potential to improve the efficiency of processes, promote more substantiated decision making, reduce the risk of errors and misappropriations, ensure the adherence with laws and instructions as well as increase the trust of investors and other stakeholders on the financial reporting of the company. The primary objective of internal control was determined to be the ensuring of adequate risk management within the case company, while bearing in

mind the materiality of the risks controlled, as over-control can have adverse effects on efficiency and ultimately on the company's profits.

Understanding and depicting processes was known to play a major part in the internal control project and also in the sustaining of the model after the initial kick-off project. Therefore a secondary objective set for internal control in the company was only naturally the assessment of the effectiveness and meaningfulness of processes and controls within the company and to establish any synergies where applicable. To further support this objective and also to ensure the timeliness of information on the state of internal control, a yearly update routine was specified to be a part of the internal control process.

3.3.2. Internal control policy of the company

Minding the above mentioned objectives and utilizing the COSO Internal Control Framework as a reference, an internal control policy for the company was drawn up. The policy defines the company's internal control as a whole that consists of the processes, procedures, structures and instructions by which the company pursues to ensure the achievement of its goals. These goals were defined according to COSO (2013):

- The efficiency and appropriateness of processes
- Safeguarding of assets
- Reliability of financial reporting
- Compliance with laws and regulations as well as principles defined by the company.

The reliability of financial reporting is separately underlined in the policy because of its pivotal role in internal control – this is partly due to the COSO framework's underlying *raison d'être*, the Section 404 of SOX, which centres

on financial reporting (Arping & Sautner, 2013). Main reason is that the correctness of the company's financials is in the end the most important factor of shareholder value. The policy therefore states that the primary objective of internal control is to ensure with reasonable certainty that the reports and accounting information provided by the company are reliable, the reporting processes are efficient and laws and regulations are adhered to.

Continuing along the lines of the COSO framework, the policy states that internal control activities are not solely the duty of controllers and other "controlling professionals", instead control activities are conducted by the board, management as well as all other employees of the company. Internal control was defined not to be a separate or extraneous activity that is performed in addition to other work activities, rather it is an integral part of all activities and every person in the company. Internal control's main objective was defined in the policy as attaining a reasonable assurance of the fulfilment of previously stated objectives. The definition was purposefully left broad to allow a wide scope for the internal control function.

Outlining the basic elements of internal control, the case company utilized the COSO framework division of internal control to five segments: control environment, risk assessment, control activities, communication and monitoring. The model used by the company is depicted in the following figure (Figure 4) and further elaborated thereupon.

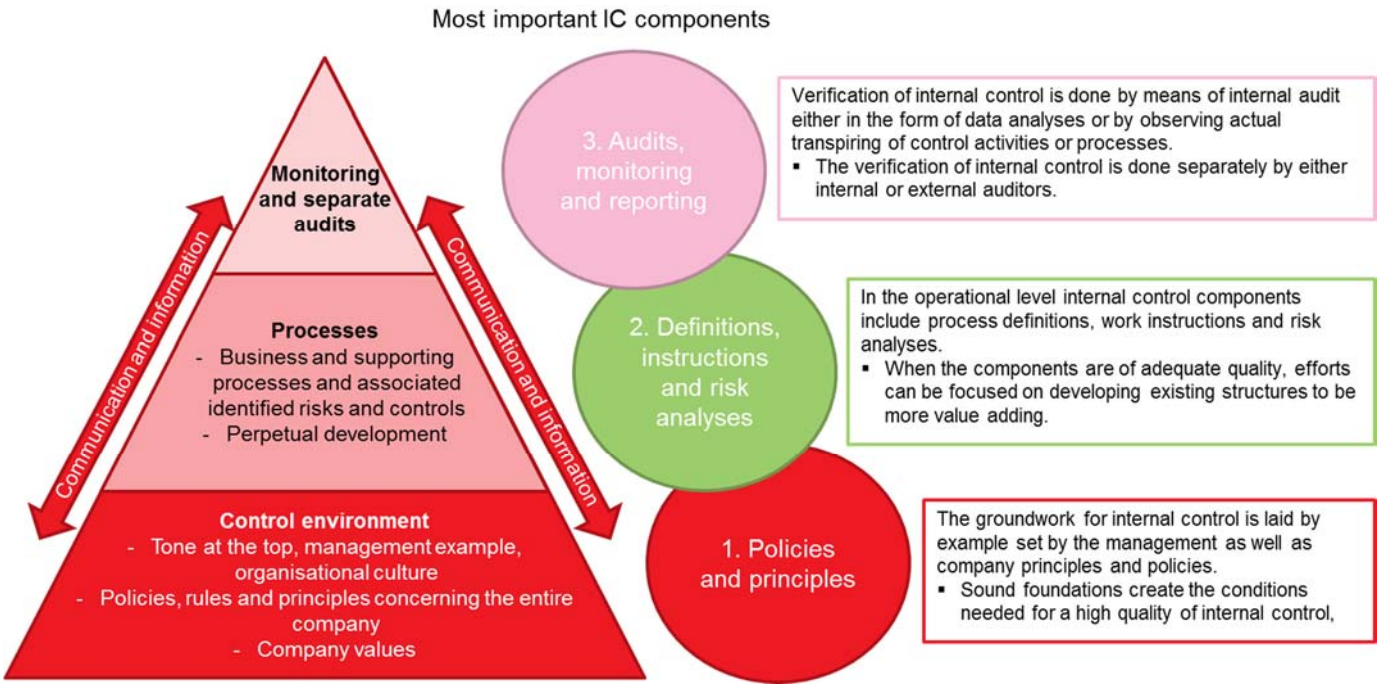

Figure 4, internal control in the case company

The foundation of internal control, control environment, in the company is constituted of ethical principles, sustainability and compliance as well as other principles and policies of the company that bring forth the general aspirations of the board of directors and management. By their actions and example the board and the management have an essential role in the forming of a control environment by setting ‘the tone at the top’. When the ambience of the company supports the thought that internal control is important, it also promotes the responsible carrying out of tasks relating to it.

Risk identification, assessment and management are a material part of internal control. A risk is defined in the policy as being an event that can have a negative effect on the achieving of the company’s objectives. Risks are primarily identified in the company as a part of the risk identification process of the strategy process as well as in daily activities. The policy also obligates every employee to report any risks that he or she identifies to

his/her superiors, so that the risks can be assessed and managed when needed.

Control activities were defined in the policy as different kinds of checks, reconciliations, analyses as well as other measures that aim to ensure the achievement of the company's objectives. The policy includes examples of control activities performed in the company, these include:

- Reconciliation of purchase order, purchasing invoice and goods received
- Solving differences between the amount of cash in a store register and amount of cash sales
- Inventory stock-taking
- Monthly analyses of financial figures vis-à-vis the budget
- Administration of user rights in information systems

Internal control policy of the case company states that the extent and magnitude of control activities must be in line with the significance of the process. There should also be a balance in automated, system-based and manual control activities. The definition continues to acknowledge that even as controlling is distributed across the organisation, they are centrally defined and connected with the company's processes.

In order to verify the adequacy, current relevance and efficacy of the control activities, the company monitors the state of internal control. Not stated explicitly in the policy as the function had not yet been formed at the time, the primary monitoring apparatus for internal control verification in the company is internal audit, whose operating principles were defined in a separate policy document formed at a later date. The policy asserts that the system of internal control is actively developed and reinforced should the company's control environment, structure or scope of activities change. According to the policy responsible for this continuous development is the

operative management, however it is also stated that ultimately the board is obliged to ensure the proper and satisfactory functioning of internal control in the company. Other monitoring parties include the company's controllers and store process auditors who continuous analyses and reports as well as external auditors (statutory auditors, ISO-quality auditors etc.) who conduct audits and other probes.

The company's management is responsible of communicating clearly the duties and responsibilities associated with internal control within the organisation to ensure the proper functioning of all the elements described earlier. All employees are obliged to communicate any and all internal control deficiencies they detect to their superiors. Departments are supposed to share information on internal control best practices and cooperate when dealing with processes that span across departments. Information and feedback received from extra-organisational stakeholders, such as customers or suppliers is also utilized, when possible, to improve internal control.

Three operational levels of internal control were identified in the case company. These 'lines of defence' were defined to be: business units, group-level supporting functions and independent auditors. The board of directors and senior management were seen to have a more strategic, steering role in internal control, acting as decision managers and setting 'the tone at the top'.

All of the lines of defence have a slightly different approach to risk management, yet in a well-functioning company all should be committed to a shared goal – benefit of the company. The composition of the control levels as well as control means are summarised in the following figure and thereupon.

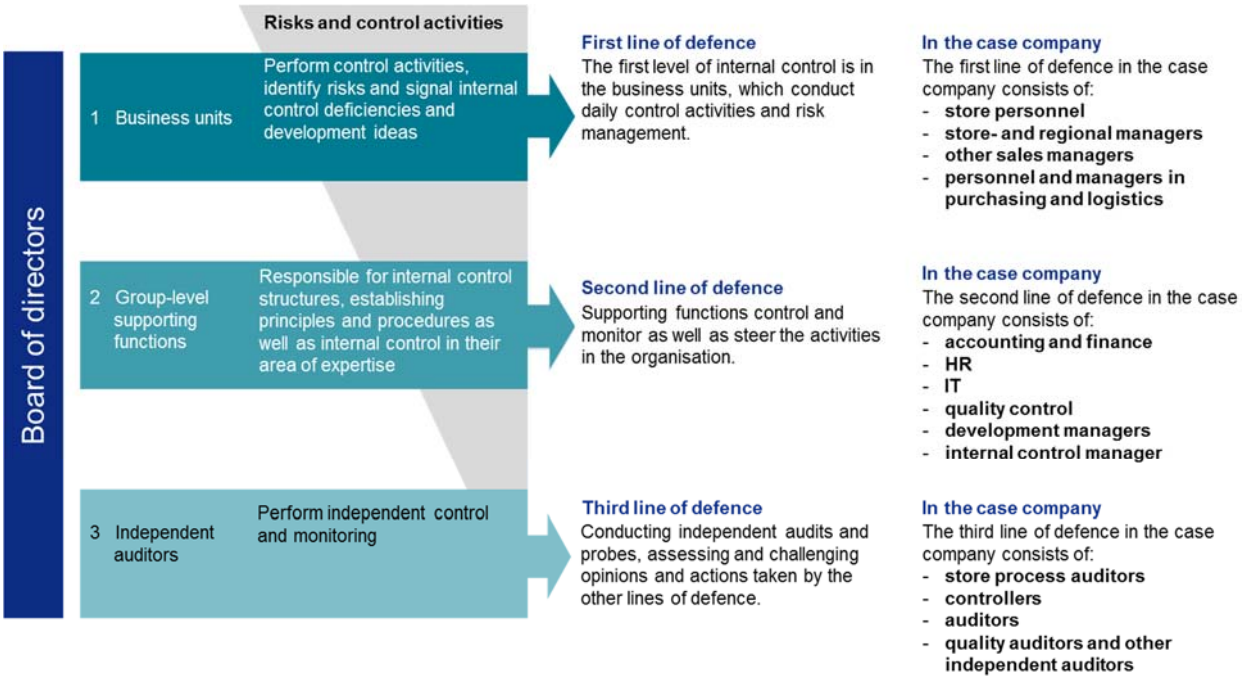

Figure 5, the case company's internal control 'lines of defence'

The first line of defence consists of personnel, who take part in the day-to-day business activities. From this position they have the best and most recent information on possible problems.

In the second line of defence are the personnel of supporting functions. By developing processes, work instructions and IT systems the supporting functions also develop internal control structures and practices. They also perform internal control activities as part of their daily routines. The company has also appointed an internal control manager, who has a substantial role within the second line of defence. He coordinates internal control development and ensures that departments conduct internal control in a corresponding way.

The third line of defence is formed by independent internal and external audit functions, which perform audits and report their findings to the management and board. Internal audit is not a separate function in the case

company, instead the internal control manager of the company as well as controllers and store process advisors form the basis for internal auditing when they are performing separate broad analyses or probes.

As all the later lines of defence are further away from daily business operations, the work they perform can mostly be used to identify potential internal control problems *post factum.* This further emphasises the role of the first line of defence in problem prevention.

The policy also defines the most pivotal roles and responsibilities of internal control in the company. The policy designates the board as the bearer of ultimate responsibility for the internal control of the company. Continuous assessment of the level and efficiency of internal control is defined as the board's primary duty in monitoring internal control. The quality of internal control in financial reporting is defined to be the responsibility of the CFO. This responsibility encompasses the definition and development of control activities as well as reporting methodology and financial monitoring, which are in turn conducted by the personnel of the accounting and administration department as part of their daily duties. The CFO and financial manager are to regularly identify and assess risks concerning the financial reporting process, including misappropriation risks. The superior of each department is similarly responsible for the level of internal control in his/her department. Persons responsible for the outsourcing contracts are also obliged to assure that the internal control activities of the service providers are of acceptable quality.

3.3.3. Understanding the control environment and creating an internal control process for the company

After the principles and policy had been formed it was essential to understand the control environment of the company (COSO, 2013) and to establish a systematic process to keep the internal control documentation up to date in the future. Key business operations and the principal owners of processes were therefore defined in order to understand the strategically critical components of the company's business and to lay out the most essential departments that needed to be defined. These were identified as (process/owner):

1. From purchasing to delivery
    a. Purchasing department, logistics department
2. From arrival to selling
    a. Store operations department
3. From registration to reporting.
    a. Accounting and administration department

General management processes (budgeting, KPIs, strategy) were identified as supporting and controlling processes that concern all of the departments.

The departments and main processes of the case company were depicted in the following figure (Figure 6).

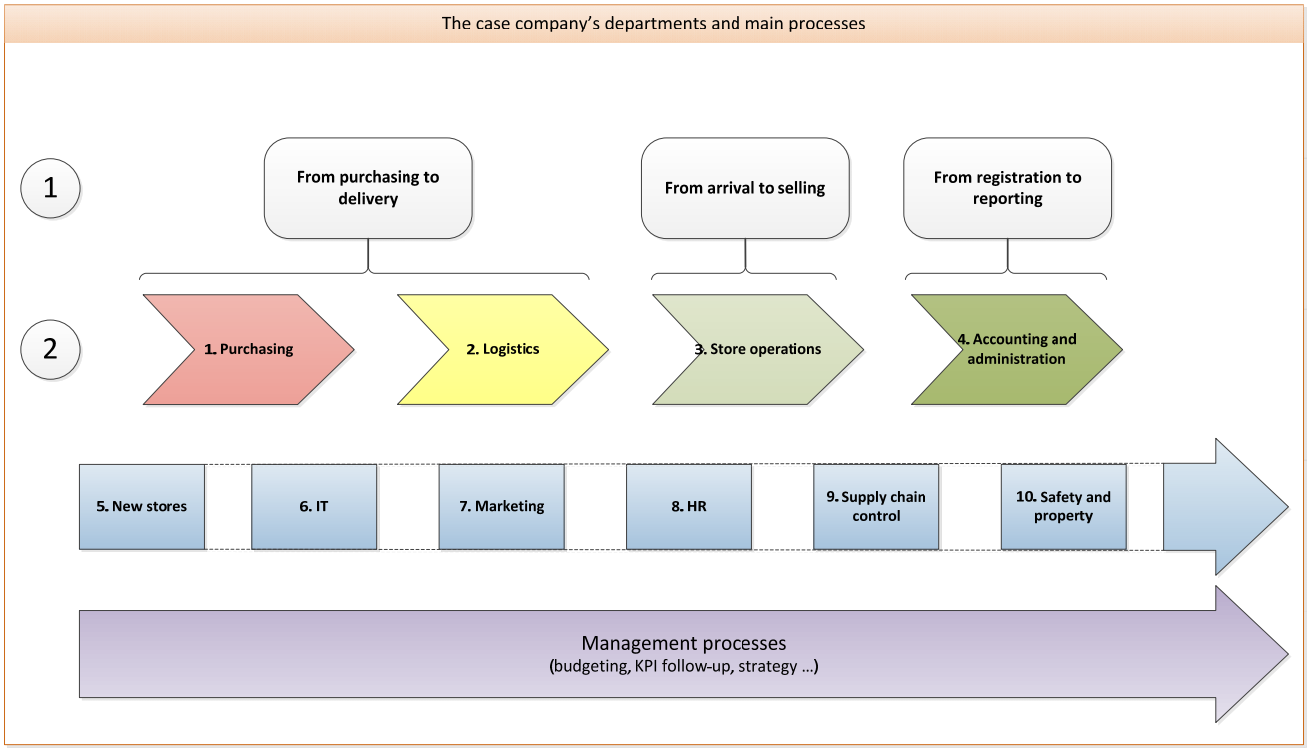

Figure 6, the case company's departments and main processes

In order to establish the control environment of the organisation, all company policies, principles and other activity governing documentation was collected and catalogued. The company-level material and information in question was:

1. listing of company policies and key principles
2. listing of IT systems and their user rights management
3. listing of obligatory law follow-up responsibilities
4. forming of a power of decision matrix
5. listing of contract templates and standard terms used by the company.

As a part of the structuring of internal control a yearly process was defined. In order for the company's internal control information to be relevant over time, the definition of key processes and controls was decided to be the

subject of a yearly update routine. The department heads' would then be required once a year to either disclose any material changes in their respective areas of responsibility or that there have been no material changes in their control environments. Immediate communication of sudden critical changes would be mandatory. Internal control of the company would be subject to a set of annual internal audits, providing assurance over the functionality of internal control as depicted.

3.3.4. Mapping out the current state of internal control in the case company

After the initial definitions, forming of an internal control policy and the definition of the company's control environment, the mapping out of the current state of internal control in the case company could begin. This was carried out by a series of interviews and meetings with each departments' representatives.

The round of interviews began with meetings that aimed to identify the key processes and control mechanisms of the departments. Secondary goal of the first meetings was to establish the information and material the respondents needed to provide in order to form a sufficient image of the processes and controls of the departments. The interviewees were therefore inquired on the existence of up-to-date process definitions and other material relevant to the definition of the department's internal control status.

The role of the IT department was considered to be a major point in assessing each of the departments' internal control responsibilities as all departments' operate primarily by using IT systems. The basic outline was that the IT department was only responsible for the controlling of risks that

had been explicitly delegated to it or that related to its area of expertise; cyber security, IT hardware and software administration and support etc. The effective controlling of risks in the systems was seen to be the burden of the end-user department, unless explicitly delegated to the IT department.

The interviews resulted in diagrams of the main processes of each department as well as matrices of their main control activities, according to the key processes and controls of the departments' that were established in the first round of meetings. These department-level diagrams and matrices together with the company-level data gathered earlier served as the cornerstones of the case company's control environment definition.

Concerning control environment, the COSO framework (2013) suggests that there should be an up-to-date definition of the company's control environment: effectively all key processes, controls and policies as well as other documentation that is of importance on the steering of the company should be documented. Therefore any unresolved issues, such as ambiguity in the processes, missing controls or other apparent shortcomings were discussed and action plans were formed to remedy the problems. Additional meetings were held with each of the departments' heads until a satisfactory understanding of the processes and controls was achieved and the definitions could actually be approved. The process flows and control activities were documented in a formal way; key controls were mapped into a table and main processes as a "work-flow" chart.

These two components were then compounded into a single score, which indicated the internal control status of the departments' processes as a whole. The status of the departments' controls were given a separate score from A to F, based on the key control matrix. Combining of these two scores with a 50/50 weight then produced the internal control score of the whole

department. A verbal summary on the status of the department was also composed. The results were exhibited in a scorecard, a model of which is shown in Figure 7.

Process		IC status	IC importance
OPR1.	Preparing for purchase		
OPR11.	Sourcing analyses	E	D
OPR12.	Tendering	C	B
OPR13.	Budgeting	C	A
OPR2.	Purchasing processes		
OPR21.	Supplier selection	D	B
OPR22.	Definition of purchase criteria	D	B
OPR23.	Negotiations	-	D
OPR3.	Pricing and control processes		
OPR31.	Pricing	C	A
OPR32.	Category management	-	B
OPR33.	Management of campaigns and stock lots	-	B
OPR34.	Product and supplier information management	D	A
OPR4.	Ordering and delivery processes		
OPR41.	Ordering processes	E	A
OPR42.	Forwarding processes	B	B
OPR43.	Store replenishment	E	B
OPR44.	Supplier invoicing processes	B	B
OPR5.	Purchase department's internal support processes		
OPR51.	Anomaly management	B	B
OPR52.	Document management	C	B
OPR53.	Quality management	D	C
OPR54.	Monitoring and reporting processes	B	A
PROCESSES TOTAL		48 % / C-	
CONTROLS TOTAL		73 % / B	
DEPARTMENT OVERALL		60 % / C+	

Figure 7, department scorecard

The verbal assessments and scorecards were then presented to the management of each department and discussed accordingly. Based on the departments' summaries, a company-level scorecard and a verbal summary on the company's internal control status were created. All material gathered and created in the course of the project including internal control status assessments and scorecards were then explained and reviewed in meetings with the departments' representatives and made available for all management-level personnel in the case company's intranet. Overall the project was positively and constructively received.

The department level assessments were then consolidated in a single table and a company-level overall score was given as average of the department scores, weighted with the assessed "IC importance" of the department as a

whole from a company point-of-view. Besides the tabular assessment, a verbal summary was also written on the current state of internal control in company-level.

3.4 Results of the case study, findings and development needs

The internal control policy and principles of the company were modelled by using the COSO framework as an outline, while the primary objective was to fulfil the requirements on internal control set for Finnish listed companies. Minding the objective, the principal philosophy behind the case company's internal control policy and structuring were cost-efficiency and value-added approach; minimal bureaucracy and avoidance of unnecessary, non-value-adding structures. The selection of means to realise these objectives was fairly broad due to the fact that internal control requirements for Finnish listed companies are very equivocal. The Finnish Corporate Governance Code effectively only requiring the company to define the operating principles of its internal control and that the Board of Directors monitor the function of such control. The case company's policy defines the basic structure and principles of internal control in the company, thus "ticking the box" on internal control requirements of the Code.

The case study produced assessments on the current quality of internal control in the case company through process-level assessments leading up to a company-level scorecard and verbal assessment. The scorecard is shown in the following figure (Figure 8):

Department	IC importance	OVERALL	Controls	Processes
1. Purchasing	A	C+	B	C-
2. Logistics	A	B	B+	B-
3. Sales	A	B+	B	B+
4. Accounting	A	B-	A-	C-
5. New stores	C	C-	C	D+
6. IT	B	C	B-	D+
7. Marketing	D	C+	C+	C+
8. HR	B	B-	B	B-
9. Supply chain control	A	B+	B+	B+
10. Safety & property	B	B-	B	B-
OVERALL		B- / 67%	B- / 72%	C / 59%

Figure 8, company-level scorecard

It was concluded in the verbal company-level assessment that risk management processes and controls were sufficient in areas that hold the most critical risks. On control activities it was further elaborated that the level of control is mostly in line with the implications of the risks associated and with the likelihood of materialization of the risks. No critical deficiencies were identified, however the assessment stressed the fact that even though controls and processes were in place they were many times not very well defined and/or thoroughly understood, further explaining that this can result in higher personnel risks as well as in the emergence of unpredictable risks and inefficiencies.

The assessment recognized that process documentation and understanding of processes was the most problematic internal control component and in need of further development, especially in certain departments. The least structured processes were at the IT, new store and purchasing departments, where needed relevant, up-to-date process documentation, work instructions or other coherent process descriptions either did not exist or they were obsolete, at least to an extent. Poor process definitions are a risk factor in internal control, as processes and other

structures are one of the five key components in the COSO framework. A poor grasp of key processes increases control risks as it is harder to clearly understand the end-to-end impact of the process and the relevance of existing control activities or the need for new controls. Documentation of processes also carries with it important efficiency implications, as it makes things like the development of systems and processes as well as substitution easier.

Existing process documentation by the IT department mostly consisted of scattered, duplicate or obsolete policy documents, disordered instruction documents and an outdated system integrations map, while existing control documentation was practically non-existent. Such absence of documentation can pose considerable risks as poor or out-of-date control environment understanding hinder risk identification and facilitate ineffective, poorly controlled processes as well as loopholes for malfeasance. For example the risk for data breaches and industrial espionage is considerably higher if no policy or other instructive documentation for information security exists. Insufficient documentation also highly increases operational and personnel risks as large shares of critical information is silent.

Primary reason for the disarray and lack of documentation in the IT department was the historically fairly lax company-level requirement concerning documentation. The documentation routines were not entirely enforced and there was largely a lack of appreciation for the regular public updating of documents. As a result of the initial discussions, new process definitions were created, system integrations map was updated and key control mechanisms were described. There were however no material deficiencies in internal control within the IT department, despite poor definitions considerably increasing the opaqueness of the department’s internal control activities and increasing personnel related risks.

The new store establishing department was a new structure within the company, having been enacted about a year earlier. The manager of the department had previously worked as a regional sales manager and was still in the beginning of the department's start up -process. Being a relatively new department there was practically no material to work with as many of the processes were new. The interviews therefore centred on understanding the main process flow and essential controls, the end result was a tolerably coarse baseline for the department's internal control structure.

As a whole, the case company seeks to be as dynamic and agile as possible and a major part of this agility is the ability for swift decision making and a readiness to reshuffle any processes or structures necessary to facilitate the needed change. Efficient purchasing is a key element in the retail industry, which was evident within the case company's purchase department. A great deal of documentation did exist at the time of the interviews and some of it very recent, yet the vast majority of the documentation was outdated as there had been fundamental changes within the purchasing department and the implementation of some of the changes was actually on-going at the time.

The need for further development of processes and adding of further depth to the process definitions in some of the case company's departments was therefore the key development need identified during the study. Due to ambiguous requirements on internal control and virtually no monitoring there had not been notable efforts to create up-to-date process definitions in some of the departments prior to the internal control structuring, this was the case in the IT department. Other departments were either very recently formed (new stores) or had either ongoing or very recently reworked processes (purchasing), which resulted in relatively shallow process definitions. These shortcomings could be resolved by conducting a

systematic process definition project within the departments that had poorly defined processes.

According to the maximal efficiency objective of the internal control structuring project all available and up-to-date material was used “as is”, when deemed possible. From an efficiency point-of-view the approach was good, as the material does not have to be separately updated and changes in processes or documentation would be “automatically” updated. As a part of the approach no requirements had been set for the form that the documentation had to be in (except for the matrices filled during the process; controls, user rights etc). This resulted in a colourful and non-uniform collection of text documentation, process diagrams, Excel-workbooks, pictures and so on, which made it quickly apparent that a systematic and efficient appraisal of the material that would be fair and neutral was very hard. A uniform model for internal control documentation and the possible introduction of a quality management system could be future development needs.

Due to the low level of hierarchy there didn’t seem to be an apparent reason for mapping out the reporting structure and reporting hierarchy of the company, as it was presumed that the organizational chart would represent sufficiently the reporting hierarchy of the company. For the most part this is true, however the mapping process brought up the fact that the organizational chart leaves out certain “cross-department” reporting, the understanding of which could provide sources for reporting synergy. Most certainly a future development need.

3.5 Fulfilment of objectives

Current literature on internal control seems to be indecisive on the subject of best practices; there are suggestions that the overly bureaucratic and elaborate approach of SOX is value-destroying, while the European "*laissez-faire*" approach is seen as too soft by many. When considering the company's objectives for internal control and its low level of hierarchy it would most certainly have been overkill to comply with SOX standards while the introduction of certain COSO aspects still produced more information and structure to the company's internal control than would have been achieved by only seeking to fulfil the bare minimum of the Finnish listed company requirements (stating the principles of internal control).

The recognized and expected core benefits of a centrally monitored internal control model was a cross-department understanding of processes and controls, which enables the refinement of processes and discovery of cross-department synergies and the development / dismantling of controls towards a centrally defined risk-benefit balanced level of control, which would result in lower control costs while the quality internal control should not suffer – this being the direct and imminent value adding aspect of structured and defined internal control. Other benefits of the model include up-to-date reporting of the current state of internal control and processes across the departments. As an extension of the internal control function a "controlling team" was formed during the project. The controlling team is an organ consisting of controllers or key personnel with controller-like work assignments and understanding from each department. This "controlling organ" of the company would convene at least once a month and discuss current control and reporting related developments within the company, seeking to dismantle overlap and find new sources of efficiency, while simultaneously championing effective and adequate control. The

company's Internal control manager is part of the team and it reports to the CFO of the company.

The primary purpose of a systematically and centrally monitored internal control was to assure the adequate level of internal control, provide valid up-to-date information on the state of internal control and risks in the company as well as dissembling unnecessary, counterproductive controls and finding sources of synergy across the company's control environment. An annual update routine was defined to achieve the objective concerning the timeliness of information on internal control. The scope of the internal control monitoring process had also been defined so that it was to appraise the adequacy of the controls in contrast to the risks associated, the systematic verification of the controls had knowingly been excluded from the objectives.

It had been decided that for this purpose an internal audit process would be introduced with its own policy and other scope-defining documentation. The policy and outlines for internal audit were established in the year 2015, during which the first internal audits were also conducted. The first batch of internal audits consisted of 8 audit subjects within the case company. As an instrument of internal control validation, the internal audits found no material weaknesses in internal control, supporting the assessments made during the internal control definition project that was the subject of this study.

Overall, the internal control structuring:

- Fulfilled the requirements of the Finnish Corporate Governance Code.
- Managed to provide a company-wide assessment on the status of internal control in the case company and identify development needs within departments.

- Provided a platform for the identification of overlapping control and processes, making it easier to promote synergy across departments.

4 Conclusion and summary of findings

The separation of ownership and control in companies has continued in the last decades. This development is mostly due to the continuous expansion of the stock market and an increase of direct investments in privately owned companies, as stock market listings and private placements are evermore commonplace, even in the traditionally majority-owned European corporate landscape. The result of the separation is that companies are increasingly directed by “professional managers” with no ownership stakes, who usually have different interests than the company owners. The company management has to have decision making power to function properly and effectively. This decision making power results in agency costs as it is both impractical and bordering on the impossible for the investor to have control over all operative decisions made in the company. In order to minimise agency costs associated with the separation of ownership and control, the investor must therefore delegate decision making while overcoming the opaqueness of the company’s operations within an extent that is in proportion to the decision making power that has been delegated to the management.

Knowing the scope and structure of the business is a very basic prerequisite for delegating decision making powers, as it is crucial for overseeing and understanding the validity of the management’s decision making. Yet understanding the structure and outlines of the business alone is insufficient as the operations will still remain under a veil of ambiguity. Without proper monitoring mechanisms the management is effectively left to their own devices, making it possible for them to make decisions that contradict the company’s interest. It is therefore essential for investors who only hold a stake in a company without participating in the day-to-day management to employ internal controls and internal control structures as well as other control and monitoring mechanisms such as appointing an audit committee

within the board of directors and establishing internal audit. These mechanisms, when properly defined and enforced, enable the owners to be reasonably assured that the operative decision making and conduct of the management is in accordance with accomplishing company's objectives and that the business operations correspond with the company's internal guidelines as well as laws and regulations.

The primary objective of this study was to structure the internal control environment of the case company and ensure its adequacy to comply with the requirements that obligate a company listed in the NASDAQ OMX Helsinki stock exchange. The requirements concerning internal control of a listed company in the Helsinki stock exchange are found in the Finnish Corporate Governance Code published by the Securities Market Association of Finland. The primary and the only direct internal control requirement is that the company shall define the operating principles of internal control, further elaborating that "*to ensure its profitable operations the company must regularly control its activities*". Relating to this requirement, the Code also requires to disclose the manner in which the internal audit function of the company is organised. Although not directly a requirement of concerning internal control, the main purpose of internal audit is typically the verification of internal control adequacy.

No prior internal control or internal audit policies existed, prompting the forming of both policies. Due to the fact that the case company is fairly large and its ownership structure has been such that a majority of the shares are owned by outsiders it was clear from the get-go that a large variety of internal control mechanisms were already in place. The internal control policy defined for the case company aimed to centrally monitor and administer the internal control system of the company and to provide up-to-date information on the state of internal control to the audit committee and management of the company. Secondary objective, not explicitly defined in

the policy, was a value-added perspective of the control by means such as finding sources of synergy in the control environment and the dissembling of unnecessary bureaucracy and excessive controls while minding the fulfilment of the primary objective of adequate control.

The basic structure of internal control was defined utilizing the most widely used internal control framework, the COSO Internal Control Integrated Framework. However as the COSO approach to internal control is of US origin where internal control requirements are very strict due to the internal control provisions of the SOX Act, which has sparked public as well as academic debate over the cost of its internal control requirements, the COSO framework was deemed to be excessively intricate and laborious to be implemented to its fullest extent in the case company, which has a low level of hierarchy and a relatively simple business model and general structure. The framework was therefore only used as a reference for the internal control model of the company, resulting model being a loose adoption of the COSO Integrated Framework.

As the Framework is thorough by nature, it provided a sound foundation and well-tested basic tools for implementing an internal control model. Due to its high adoption rate and status as a standard for internal control systems in the US, utilization of the COSO framework could also provide an easier transition should there ever be tightening of regulations over internal control in Europe or should the case company ever decide to up the ante for example in the form of implementing a quality management system. Modelling of the policy and internal control structures as “a light adaptation” of the COSO Internal Control Integrated Framework did easily fulfil the current Finnish and European minimum requirements on internal control and also provided a basis for further development, should there be either an external or an internal pressure to do so. The adaptation being light and striving for a less bureaucratic approach and “risk-benefit optimal” level of

internal control, the model employed also serves higher efficiency objectives.

The structuring and defining process of internal control in the case company left a need for the further development of process definitions – this was especially the case for departments that had recently been formed (new stores), notably restructured (purchasing). Other departments had previously no proper internal or external pressure to have proper, up-to-date documentation. Some over-control and under-control situations were also detected, while some control activities were identified to be overly complex or manual – from the company level-of-view these were merely efficiency-related issues. There were also a few points identified in the internal control structure that needed development. The control environment of the company was established by mapping out the main processes of the company and the departments, this was done by utilizing existing material to the maximum extent. However when the structuring was completed it was painstakingly obvious that in order for the assessments of internal control in the departments to be neutral and efficient they would have to be more uniform. The primary development need was therefore to establish a universal platform for depicting processes that would not require making separate process definitions and would still be relatively uniform. This would probably be easiest to achieve by introducing policies that dictate the forms all future documentation in the company should be presented in. Another possible future development would be the introduction of a quality management system, in which all key processes and controls would be maintained.

Another secondary objective of the study was to reflect what value internal control can produce in the case company. The most obvious of reasons for internal control is its value in the protection of shareholder assets – proper internal control reduces the risk of invalid financial information and

misappropriations, therefore upholding shareholder value. This objective was achieved in the sense that internal control related issues were previously not communicated to the board of directors in a structured and systematic manner, instead reporting relied mainly on the communicated assessments of the annual statutory audit and irregular assessments and communiques of the operative management.

Typically most internal controls themselves are enabling as many processes would either be interrupted, disrupted, inefficient or incur additional, superfluous costs further along the line, should there be no relevant internal controls in place. For example a sampling quality check upon the first arrival of new goods can result in the starting of a supplier complaint process concerning substandard products, which in turn can lead to significant cost savings when compared to the lack of such control, which would result in the conveying of non-marketable goods further along the supply chain and a costly product recall process from consumers. This is the other key value-adding aspect of internal control. Over-controlling on the other hand can lead to value-destroying situations as the cost of the control or the inefficiency resulting from a laborious control can overshadow the economic gains of the control. This might be the case, should the earlier example on quality control be done with excessive precision (e.g. controlling of every single product instead of a sample test).

Third source of value in structured internal control is the assuring of the existence of proper processes and related documentation. First and foremost this is a source of operational efficiency but also a matter of reliability, as without documentation there are no “rules” or framework within which the process should operate and against which it can be assessed. Undocumented processes also rely heavily if not entirely on silent information which may prove to be a problem (at least from an efficiency point-of-view) if there are changes in personnel.

The primary value-adding functions of structured internal control are therefore the assurance of operational efficiency through the existence of proper processes and related documentation, the recognition of under- and over-control situations as well as the safeguarding of assets and assurance of financial information as a part of upholding shareholder-value. The internal control definition in the case company produced a structure and process concerning internal control assessment in the company, which upholds shareholder-value by providing the board of directors with systematic assessments on the state of internal control in the company and aims to find sources of further efficiency by optimizing the level of control.

The study also aimed to assess how internal control policies and processes should be defined to be value-adding (or cost-efficient) yet still meaningful and shareholder-value upholding. This was to be a question of control relevance in respect to the risks associated, while it is paramount that the information be current. As shareholder-value can be undermined by overly laborious control ("controlling business to death") there would have to be some sort of guidelines for control relevance. The case company sought to tackle this by centrally appraising "control optimums" in the context of the whole company's business by using a universal template for the risk-benefit assessments (the same as the company's ERM process), minding a cost-benefit point of view. Yet the main focus of centrally managed and monitored internal control was still to be risk management, as it was defined in the policy.

The study managed to create an internal control model for the company, relying on the underlying theses of the COSO Integrated Internal Control Framework, that fulfilled the current regulatory requirements and seemed to provide useful efficiency-feedback and new sources of efficiency as well as providing timely information on the state of internal control in the company

for the owners and the managers. However it seems to be fairly obvious from the implementation process and the results that an internal control model cannot be a rigid “one-size-fits-all” solution and still serve an efficiency objectives yet it can’t be too loosely defined or its value as a provider of meaningful internal control insight to the board will suffer. The case company’s example would suggest that the “rigidity/leeway” equilibrium of an internal control model should be assessed in light of the target company’s culture, age, size, complexity as well as the existence of other corporate governance structures. The case company’s departments provided some evidence from such factors in scale and some internal control weakness “red flags” could be identified (age of department, initiative of the departments vs. “follow-orders” mentality etc).

Further research should be done on the implementation of centrally led internal control systems, as this study lacks a large enough sample and cannot therefore be a representative sample. An interesting subject would also be “red flags”, meaning company or intra-organisational characteristics that imply the need for stricter or stiffer internal control management, or vice versa. The single case study sample also provides with a very narrow point-of-view regarding the internal control needs of different industries; retail business is very different from the banking industry, for example, where requirements are much higher. Another interesting point is the context of the regulatory framework – a company that needs to adhere to the SOX Act of the US, a cross-listed company for example, would provide a very different sample.

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APPENDICES

APPENDIX 1: Table of interviews

Title	Department	Role in internal control	Duration of tenure	Date of interview(s)
CFO	Administration and finance	Head of administration and finance department.	Over 5 years	17.1.2014; 3.3.2014; 6.3.2014; 13.10.2014
Financial manager	Administration and finance	Operative management of accounting and finance. Accounting controls, financial statements and reporting.	2 years	6.5.2014; 28.5.2014; 16.6.2014; 27.8.2014
Head accountant	Administration and finance	Accounting team leader. Reconciliations, taxes, validity of accounting.	1 year	6.5.2014; 28.5.2014; 16.6.2014; 27.8.2014
Controller	Administration and finance	Operative sales reporting, assisting in monthly internal sales reporting, sales reconciliation and controls.	1 year	6.5.2014; 28.5.2014; 16.6.2014; 27.8.2014
Financial controller	Administration and finance	Financial controls and reconciliation. Company implementation of IFRS, preparing of IFRS statements.	2 years	6.5.2014; 28.5.2014; 16.6.2014; 27.8.2014
Business controller	Administration and finance	Internal reporting development and controls, budgeting process and controls. Monthly internal	3 years	6.5.2014; 28.5.2014; 16.6.2014; 27.8.2014
HR director	HR	Head of HR department.	Over 5 years	11.4.2014
Payroll manager	HR	Payroll validity controls and reporting.	Over 5 years	11.4.2014; 22.5.2014; 11.6.2014
Systems manager	IT	Further development IT systems and new system implementation. Current information system monitoring.	Over 5 years	14.4.2014; 30.6.2014; 3.7.2014; 5.9.2014; 5.5.2015; 2.6.2015
Computer infrastructure manager	IT	Maintaining and monitoring of networking and devices, system backing-up.	Over 5 years	14.4.2014; 30.6.2014; 3.7.2014; 5.9.2014; 5.5.2015; 2.6.2015
IT services manager	IT	Operative computer servies (helpdesk), repairs.	Over 5 years	14.4.2014; 30.6.2014; 3.7.2014; 5.9.2014; 5.5.2015; 2.6.2015
CTO	IT	Head of IT department.	Over 5 years	5.5.2015; 2.6.2015
Warehouse managers	Logistics	Distribution centre management and reporting.	Over 5 years	5.5.2014; 28.5.2014; 25.6.2014; 29.8.2014; 27.5.2015
Warehouse administration team leader	Logistics	Distribution centre stock taking and information quality management, shrinkage reporting.	Over 5 years	5.5.2014; 28.5.2014; 25.6.2014; 29.8.2014; 27.5.2014
Logistics manager	Logistics	Head of logistics department.	Over 5 years	27.5.2015
Controller	Marketing	Marketing department reporting, controls and analyses.	Over 5 years	8.5.2014; 26.8.2014
Manager	New store establishing	New store establishing and budgeting. Construction of new property.	1 year	6.5.2014; 2.6.2014
Development manager	Purchasing	Financial processes, control procedures and reporting in the purchasing department.	Over 5 years	14.4.2014; 5.9.2014; 26.5.2014; 17.12.2014
Forwarding manager	Purchasing	Imported goods processes, controls and reporting.	Over 5 years	14.4.2014; 5.9.2014; 26.5.2014; 17.12.2014
Supply chain manager	Purchasing	Automated store and warehouse replenishment and related processes, controls and reporting.	3 years	14.4.2014; 5.9.2014; 26.5.2014; 17.12.2014
Quality manager	Purchasing	Product quality processes and supplier quality and compliance assurance.	Under 1 year	14.4.2014; 30.6.2014; 4.7.2014; 1.9.2014; 5.9.2014; 26.5.2014; 17.12.2014
Purchasing director	Purchasing	Head of purchasing department.	1 year	5.9.2014; 17.12.2014
Head of safety and property	Safety and property	Overall responsibility of property and physical safety matters, inc. staff health & safety and theft.	Over 5 years	16.4.2014; 15.5.2014
Property manager	Safety and property	Property maintenance and related processes, controls and reporting.	1 year	16.4.2014; 15.5.2014; 23.5.2014
Security manager	Safety and property	Store safety, theft deterrence and internal investigation.	Over 5 years	16.4.2014; 15.5.2014; 23.5.2014; 8.7.2014
Development manager	Sales	Store reporting and sales development reporting.	3 years	14.4.2014; 9.6.2014
Process manager (store operations)	Sales	Store processes, process development and controls.	Over 5 years	14.4.2014; 9.6.2014; 22.7.2014
Sales manager (wholesale, online)	Sales	Processes, controls and reporting of online and B2B sales.	1 year	14.4.2014; 9.6.2014; 17.6.2014; 29.7.2014
Management consultants (KPMG)	-	Consulting on developing of the internal control framework for the company, internal control policy.	Consulting basis	21.1.2014; 5.2.2014; 6.3.2014

APPENDIX 2: Department control matrix example

Main process	Sub-process	Process phase	Control name	Risk	Control activity	Tresholds	State of control (3-0)	Recurrence of control	Responsible for the control
OPR4	OPR44. Invoicing	Foreign purchasing	Payment status	Paying twice	Setting payment status in ERP	No implicit tresholds	1	Each purchase	Forwarding manager
OPR5	OPR54. Monitoring and reporting	Purchasing contract	Existence of purchase contract	Unclear and opaque payment and delivery terms, misappropriation	Checking the existence of valid contracts and relating appendices	Contract exists / contract missing	1	Each month	Purchase department development manager
OPR4	OPR44. Invoicing	Purchase outside the EU	Supplier bank information verification	The invoice has not been prepared by the supplier, fraud	Comparing payment information on invoice with purchase order, supplier information in ERP and supplier information in accounting. Contacting the supplier by phone when needed.	No implicit tresholds	2	Each invoice	Forwarding manager
OPR2	OPR22. Purchase criteria	Product approval	Physical inspection of arriving products	Product recall risk, reputation risk	Examining of a random sample product from the order before delivery to stores	Product complies with definitions / does not comply	2	Each week	Product quality manager

APPENDIX 3: Risk assessment matrix

	1 Insignificant	2 Minor	3 Moderate	4 Considerable	5 Critical
General assessment	Impact either minimal or transitory, objectives can be seen as entirely fulfilled when considered overall		Moderate implications, yet objectives can be seen as mostly fulfilled in overall consideration		Very large implications, failure in fulfilling objectives, "the worst possible happens"
Financial implications	Insignificant P/L impact, "a few hundred euros"	Minor P/L impact, "a few thousand euros"	Moderate P/L impact, "tens of thousands of euros"	Considerable P/L impact, "a few hundred thousand euros"	Critical P/L impact or business interrupting implications, "over a million euros"
Customers	Insignificant impact on single customers (eg. rare and minor factory defects on products).	Minor impact on a limited number of customers (eg. short-term availability problems of single product categories).	Moderate implications on customers or sales (eg. delivery problems with a significant supplier).	Business is disrupted or interrupted for a short period of time or in a limited area. Considerable Implications on customers or sales (eg. interruption of payment verifications).	Business is disrupted or interrupted for a prolonged period of time. Critical implications on customers or sales (eg. strikes, epidemics).
Reputation	Insignificant impact on company reputation (eg. single and minor complaints from customers).	Minor impact on company reputation (eg. writing on local news papers).	Moderate implications on company reputation (eg. negative attention in a regional media).	Considerable implications on company reputation (eg. short-lived negative national media attention).	Critical implications on company reputation (eg. extensive and long-term negative nationwide media attention).
Personnel	Insignificant impact on single employees or operations (eg. single occupational accident).	Minor impact on single employees or operations (eg. single serious occupational accident).	Loss of key personnel, workforce or skills that have moderate implications on operations (eg. departure of several employees from middle management in a short period of time).	Loss of key personnel, workforce or skills that have considerable implications on operations (eg. departure of more than one senior managers).	Loss of key personnel, workforce or skills that have critical implications on operations in the long term (eg. departure of the whole senior management).