

CITY UNIVERSITY OF HONG KONG
香港城市大學

**An Empirical Study of the Effectiveness
of Internal Control over Financial Reporting
– The Effect of Audit Committee Quality
and Participation in IT Governance**

財務報告內部監控有效性之實証研究 –
審核委員會質素及其參與資訊科技管治的效應

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By

Tang Lai Wah
鄧麗華

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ABSTRACT

High quality financial reporting and good corporate governance, including effective internal control systems, are key factors in improving economic efficiency and enhancing investor confidence in financial markets. The Sarbanes-Oxley Act (SOX) of 2002 emphasizes the importance of reviewing the effectiveness of internal control over financial reporting (ICOFR). Because a company's audit committee performs the critical role of reviewing internal control, the quality of the audit committee should affect the effectiveness of ICOFR. In an era in which technology is increasingly critical to business, IT is the foundation of an effective system of ICOFR and corporate governance is incomplete without adequate IT governance.

Given the limitations of using dichotomous variables in U.S. studies, the unavailability of voluntary corporate disclosure of information on the effectiveness of internal control in Hong Kong, and the lack of information about audit committee participation in IT governance, this is the first study to use a survey approach to assess the effectiveness of ICOFR based on the five components of the COSO internal control framework. The survey questionnaire was mailed to the Chief Financial Officers (CFOs) of 874 Hong Kong main board listed companies. Completed questionnaires were received from 108 companies, representing a response rate of 12.36%.

The current study consists of two essays. The first essay examines the association between audit committee quality and the effectiveness of ICOFR, and the moderating

effect of family control on this relationship. The second essay examines the association between audit committee participation in IT governance and the effectiveness of ICOFR. The empirical results reveal a positive association between audit committee quality and the effectiveness of ICOFR. This suggests that an effective audit committee can strengthen the review and monitoring of a company's internal control system. The empirical results also show that the moderating effect on the positive association between audit committee quality and the effectiveness of ICOFR is stronger in non-family controlled firms than family-controlled firms. This suggests that non-family controlled firms utilize their audit committees more effectively to improve the quality of ICOFR. The results indicate that audit committee participation in IT governance has a positive association with the effectiveness of ICOFR. The results also indicate that audit committees should participate in IT governance at board level. The findings advance our understanding of corporate governance in areas related to the measurement of internal controls and audit committee quality, and the importance of IT governance to the effectiveness of ICOFR. The study adds to the literature by examining the effects of family control on corporate governance practices. The findings provide useful empirical evidence for the Hong Kong regulators and policy makers on the evaluation and improvement of corporate governance regulations. The research also provides insights into the development of requirements for internal controls over financial reporting for professional accounting bodies.

Keywords: Internal Control over Financial Reporting; Audit Committee Quality; Family Control; IT Governance