The Impact of Family Ownership on Quality and Disclosure of Internal Control in Pakistan

Imran Abbas Jadoon 1,*, Umara Noreen 2, Usman Ayub 1, Muhammad Tahir 1 and Naima Shahzadi 1

1 Department of Management Sciences, COMSATS University Islamabad, Islamabad 45550, Pakistan; usman_ayub@comsats.edu.pk (U.A.); m_tahir@comsats.edu.pk (M.T.); naimashahza@gmail.com (N.S.)
2 College of Business Administration, Prince Sultan University, P.O. Box 6633, Rafha Street, Riyadh 11586, Saudi Arabia; unoreen@psu.edu.sa
* Correspondence: imran.jadoon@comsats.edu.pk

Abstract: The role of family owners in the internal control environment is characterized by contradictory theoretical arguments i.e., entrenchment and alignment behavior. Therefore, the objective of this study is to investigate the behavior exhibited by family owners concerning the internal control environment in an underdeveloped regulatory setting. The study collected both primary and secondary data to use a multivariate regression research design to investigate the impact of family owners and CEOs on the internal control quality and disclosure of enterprises. The results of the current study demonstrated that family owners and family CEO have a negative impact on the internal control quality and disclosure, which validates the entrenchment behavior exhibited by family owners in the Pakistani setting. The results of the current study imply that policymakers should promote strict policy initiatives regarding the effectiveness of internal controls and their reporting so that companies are compelled to have better engagement in internal control practices for the protection of minority shareholders.

Keywords: family-owned firms; entrenchment effect; alignment effect; internal control quality; internal control disclosure

1. Introduction

The ownership structure is an essential governance mechanism that helps to align the interests of shareholders and managers. It has been found that family ownership and family control is the most prominent organizational structure that plays a vital role in economic development of a country and around the globe almost 80 percent of businesses are owned by families [1–3]. Likewise, in Pakistan, family businesses are leading in the business community and playing a significant role in the expansion of the national economy. Furthermore, it is observed that business mostly have a concentrated ownership and the firm’s ownership is held by family groups [4]. Although, family businesses may have strong incentives for monitoring and decision-making power in management practices, however, it has been argued that standard corporate governance practices including independent boards, board committees and higher quality disclosure are less relevant in family firms [5]. Because family shareholders hold dominant positions they can confiscate wealth from minority shareholders and subsequently manipulate the financial statements to preserve the family’s reputation [6].

Consequently, these circumstances create a principal-principal agency problem which arises due to conflict of interest between the controlling family shareholders and minority shareholders [7]. The family-based organizations tend to have higher levels of principal-principal conflict as they control significant segments of shares in firms and carry out decisions accordingly. Mainly, the grouping of owners and managers in the form of the family may result in undesirable outcomes due to the likelihood of expropriation of firm resources, which refers to the inappropriate transfer and use of organizational resources by...
the majority shareholder as compared to minority shareholders [8,9]. However, corporate internal control systems can be used as a tool to overcome this principal-principal agency cost by defining strategies and mechanisms to ensure the protection of the organization’s resources, credibility of financial reporting as well as ensuring the use of appropriate financial management practices for the long-term economic sustainability of firms [10]. Furthermore, internal control is engaged in providing reliable and comprehensive information to financial participants which enhances the quality of financial reporting and moderates the governance problems [11].

Internal control is the system of rules and regulations that determine whether financial transactions are accurately reported, the management plans and procedures are effectively operated, and organization assets are properly protected [12]. The primary role of internal control is to provide a reasonable assurance that the organization management utilizes the designated financial wealth in a suitable way that will protect the concerns of both large and minority shareholders. It strengthens the internal operations, assessment, risk management and discloses accurate information to the stakeholders [13]. Furthermore, an effective and well-designed internal control system helps to detect fraud, prevent wastage of financial assets, and helps reduce management deficiencies. It is based on accounting procedures and systems designed to improve efficiency and effectiveness of organizational operations, policies and compliance that will reassure stakeholders regarding the achievement of the firm’s objectives (i.e., economic sustainability) [14]. Therefore, the sustainability of firms can be reasonably assured, for the foreseeable future, through the use of a sound internal control system [15].

Internal control is an imperative mechanism of corporate governance to defend the interests of shareholders and mitigate opportunistic managerial behaviors. Besides, it has a significant impact on management earnings and quality of financial reporting [16]. Over time, more focus has been shifted to the efficacy of internal controls. Effective internal controls improve a firm’s financial performance by minimizing the agency cost based on principal-agent and as well as principal-principal conflicts, and it also helps to mitigate economic losses in the financial market [17]. Furthermore, based on principal-principal agency theory, it has been proposed by Vural [18] that disclosure practices vary across different ownership structures and family ownership situations, having principal-principal agency problems, have a distinctive impact on disclosure as compared to non-family firms. Because family owners have a long-term presence in the organizational structure it could allow them to have an informational advantage, close ties with management and higher involvement in business decision making. Therefore, they prefer to opt for lower disclosure because it allows them to promote their self-intrinsic benefit to the detriment of minority shareholders [18].

The literature has explored the relationship between internal-control disclosure and corporate characteristics largely in developed markets or China [6,14,19–21]. These studies stated that reporting of internal-control information in annual reports is significantly related to the complexity of organizational structure, corporate value, firm profitability, board characteristics, and ownership structure [22]. However, it is necessary to re-investigate the impact of ownership structure on internal control disclosure and quality in emerging markets because the regulatory environment in developed economies differs from that in developing economies, which usually have fragile external regulatory and disciplinary procedures [23]. Thereby, this study addresses the significant question of whether family firms impact the effectiveness of internal control and the disclosure of internal control information in financial reporting because in developing economies, there is scarce literature which has explored the relationship between ownership structure, internal control quality, and disclosure [24]. Consequently, the aim of the current study is to investigate the impact of family-owned businesses on internal-control quality as well as internal-control disclosure in Pakistan. This should provide new insights into the relationship between ownership structure, internal control quality and disclosure in a fragile external regulatory environment.
The current study contributes to the literature in three ways. First, this study adds to contemporary discussion on principal-principal agency cost in relation to emerging economies where conflicts between minority and majority shareholders have serious implication for the effective internal control system in organizations. Secondly, the existing literature has mainly focused on developed markets to investigate the impact of ownership structure and internal control disclosure and quality [6,14,19–21] resulting in inclusive findings [24], whereas the current study explored this phenomenon in emerging markets which provides new insights into this relationship because the regulatory environment is quite different in emerging markets as compared to developed markets. Thirdly, in emerging economies like Pakistan, firms are mostly highly concentrated and family-owned, which provides incentives to controlling shareholders to transfer resources to within-group firms and decision-making power in management practices, therefore, family owners might indulge in entrenchment activities [4]. Based on the above-stated argument the current study delivers an opportunity to investigate the role of quality and disclosure control in a context where inefficient governance and principal-principal agency conflict is flourishing.

2. Literature Review
2.1. Theoretical Framework

The literature focuses on the relationship between ownership structure and internal control has mainly employed agency theory. Agency theory emphasizes on circumventing the problem associated with the separation of management and owners. Furthermore, it provides direction to implement effective governance mechanisms to alleviate agency conflicts. The proponent of agency theory suggested that managers should be monitored to increase firm’s value by reducing the inefficiency caused by agency problems [25]. Conversely, the concentration of ownership may also lead to misuse of organizational resources, whereby controlling shareholders can extract private benefits from organization resources and are inclined to seek excess controlling rights [26]. Furthermore, family-owned firms are most likely to have concentration of ownership, where a unique conflict of interest may arise among controlling family shareholders and minority shareholders which also creates agency costs [7]. This unique conflict is referred as principal-principal agency problem which tends to be higher in family-owned business, as family owners may control significant segments of companies’ ownership and there could be a grouping of owners and managers in the form of family members, resulting in undesirable outcomes such as inappropriate transfer and use of organizational resources by the majority shareholder as compared to minority shareholders [8].

The agency cost (principal-agent or principal-principal) can be minimized through development of internal controls. The effective internal control contributes to reducing corporate existing problems related to the inefficient structure and asymmetric information [27] (Wu and Bao, 2019). Furthermore, it can prevent improper behavior that damages the efficiency of business activities, reliability of financial reports and reduce the conflicts of interest among stakeholders [28,29]. The concept of internal control system was initiated in a report published by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The main objective of the report was to provide a universal principle of the internal control system to alleviate all types of agency problems and enhance corporate value [30]. It was suggested in the report that there are different components of internal control such as the control environment of companies, assessment of risk, control activities, and internal control monitoring. These components signal to investors whether management adopts the responsibility for establishing an effective internal control system [8]. Reporting of these elements in the form of an internal control framework helps investors to assess whether management is implementing policies and procedures at each level, or appropriate measurements are taken by the management to address risk, or management communicating and reporting internal control deficiencies to an investor. As they can evaluate the company’s ability to achieve objectives regarding company’s rules, policies, and procedures [31].
2.2. Family-Owned Business and Internal Controls

The ownership structure is an essential governance mechanism that supports the interest of majority and minority shareholders alike [32]. However, the literature provides alternative approaches (i.e., entrenchment and alignment approach) for ownership structures affecting internal control. The proponents of the alignment approach have suggested that controlling shareholders are concerned with their reputation, therefore they prefer to opt for higher internal control quality by aligning their interests with other stakeholders [20]. Furthermore, family owners have modest incentives for entrenchment because family-owned firms have undiversified, long-term, and concentrated ownership, therefore, they are concerned with long-term firm value [33–35]. On the other hand, proponents of the entrenchment approach have suggested that controlling shareholders would seek to reduce the effectiveness of internal control to serve their own interests which would decrease the likelihood of their future accountability [14]. The competing viewpoints have been strengthened by empirical evidence which is also split between alignment and entrenchment effects of controlling shareholders and resulting in inconclusive results, as discussed below.

The literature provides mixed empirical evidence regarding the relationship between family ownership and internal control quality [24]. Recently, Rostami, Bazarghani and Rostami [36], Bardhan, Lin, and Wu [14] and Weiss [20] have focused on the impact of family ownership on internal control quality in Iran, USA, and Israel, respectively. Rostami, Bazarghani and Rostami [36] have explored, inter alia, the relationship between family ownership and internal control weakness and depicted a negative relationship between family ownership and internal control weakness in Iranian non-financial firms listed on Tehran Stock Exchange. Likewise, Bardhan, Lin, and Wu [14] have documented the significant lower internal control quality and disclosure in family-owned firms in USA. Similarly, another study has shown the same findings by using a sample of high-tech firms and classifying in this group family firms that are also managed by a family CEO. The study showed that family firms managed by a family CEO result in inefficient internal control that leads to less firm growth as compared to non-family-managed firms [37]. Likewise, Oradi, Asiaei and Rezaee [38] examined the relationship between family firms’ characteristics and the internal control effectiveness, compared to non-family firms. Examining a relatively large sample of S&P 500 firms, the study reported that family-owned firms have a higher tendency of appointing family members to the board, management team and CEO positions. It is empirically found that family firms where founding members are the CEO or hold top management positions are interested in retaining weaker internal controls to derive private benefits. The study also examines the association between the family CEOs and internal control quality, thereby the results show that the presence of a family CEO or founder of the firm as a controller influences negatively the internal control quality because a qualified and skilled CEO produces more value than a family CEO. However, Weiss [20] has identified the relationship between family ownership structure and fewer material internal control weaknesses and documented that there is significant positive association between family ownership and internal control weakness.

There is another thread of literature that focuses on the relationship between ownership structure and internal control disclosure. For example, Ji, Lu, and Qu [39] examined the effect of ownership structure (i.e., institutional ownership and ownership concentration) on IC quality, as measured by the voluntary disclosure of material IC weaknesses. They document that ownership concentration has a negative effect on such disclosures. Likewise, an empirical study conducted to obtain relevant information about internal control quality in Egypt suggests that the ownership structure has a great impact on internal control. However, the findings showed that a firm having weak internal control provides a lower degree of earning quality [40]. Moreover, internal control weakness may exist due to complex financial transactions, limited resources, and weak corporate governance. It is observed that companies with a suitable ownership structure are more profitable, capable to use resources efficiently and are able to promote internal control
quality, and thereby willing to disclose internal control information in order to manage the business operations and mitigate the threat of loss of information or agency problems for investors [21]. Furthermore, it has been empirically shown that ownership structure and organization size possibly leads to disclosure of internal control statements. A firm having good governance and a well-organized structure has a great tendency to report internal control information. Nevertheless, internal control information disclosure is also adversely associated with business complexity, organizational size, and concentrated ownership [41]. However, interestingly Leng and Ding [42] reported no significant relationship between degree of ownership concentration and internal control information disclosure in China.

In sum, it can be concluded from the above discussion that both the theoretical and empirical literature that has explored the relationship between family ownership and internal control has largely focused on developed economies and reached inconclusive findings. Therefore, it is worthwhile to investigate the internal control environment in family-owned firms focusing specifically on emerging economies to enhance our current understanding of behavior (i.e., entrenchment or alignment) exhibited by family controlling shareholders in unregulated settings.

3. Methodology

3.1. Data Description

The purpose of the current study was to investigate the impact of ownership structure, more specifically family-owned firms, on internal control quality and internal control disclosure in Pakistan. The study focuses on PXS-100 non-financial firms because these firms cannot be analyzed along with financial firms due to the differences in internal control environment, operation, and financial reporting requirements [4]. The final sample of the current study was 83 non-financial companies listed on the PSX-100 excluding banks, insurance companies, mutual funds, media, and modarabas. Both secondary and primary data were collected to measure the variables, that are used in the regression analysis. Furthermore, a cross-sectional research design is employed in the study, since both the dependent and independent variables are time invariant. Primary data was collected by online questionnaires adopted from Khlif and Samaha [43] and distributed among the firm’s external auditors (see Appendix A.2). The analysis of 2019 audit reports allowed us to determine the names of the external auditors who conducted the audits, their addresses, emails and telephone number to contact them and disseminate our questionnaires. Overall, 200 questionnaires were disseminated among external auditors to gather information related to top listed non-financial firms based on market capitalization, covering the 2019–2020 accounting year. If an external auditor had multiple audit assignments, then separate emails were generated for each audit assignment. Initially, only 25 responses were received but the researchers ultimately managed to collect 83 responses after telephone contacts with the external auditors. Nevertheless, this data collection process required six months to complete. The response rate of the current study is 41.5% as 83 responses were received out of total 200 disseminated questionnaires. Furthermore, while annual reports for the fiscal year 2019–2020 were utilized to collect secondary data for internal control disclosure and control variables, firm ownership and family CEO data was collected from the shareholding information available in annual reports and websites of firms.

3.2. Econometric Model

The study employed multivariate regression analysis on cross-sectional data and regression equation are given as follows:

\[
ICQ_i = \alpha_i + \beta_1 FOB_i + \delta_i Z_i + \epsilon_i \\
ICQ_i = \alpha_i + \beta_1 FCEO_i + \delta_i Z_i + \epsilon_i \\
ICD_i = \alpha_i + \beta_1 FOB_i + \delta_i Z_i + \epsilon_i \\
ICD_i = \alpha_i + \beta_1 FCEO_i + \delta_i Z_i + \epsilon_i
\]
where ICQ is the internal control quality and ICD is the internal control disclosure of firm i, $\alpha$ is a constant and $\beta_1$ represents the coefficient of independent variables. FOB is the dummy variable which represents shares owned by a family member of firm i. FCEO is also a dummy variable representing the CEO as a controller or family member of firm i. In this study we employed firm size, board size, independent member of the audit committee and external auditor (i.e., “Big 4” firms) as control variables and they are represented by $Z$, whereas $\delta$ is used to represent their coefficients.

3.3. Measurement of Variables

3.3.1. Internal Control Quality

In developed economies, the deficiencies and modifications related to internal control are directed by financial disclosure requirements and it is the responsibility of external auditors to inspect the effectiveness of internal control as well as disclose the internal control information in financial reports [24]. However, the developing economies are unregulated concerning to internal control disclosure, hence a lack of information regarding internal control makes it difficult to operationalize internal controls directly from annual reports. Therefore, a survey research design is most appropriate for developing economics in which external auditors are asked to fill in checklists regarding internal control [43]. Accordingly, this study used this approach adopted from Khlif & Samaha [43], that is based on 23 items dealing with the organization’s role and responsibility, overall monitoring, risk management, system characteristics, information technology function, and monitoring control (for details see Appendix A.2).

3.3.2. Internal Control Disclosure

This study employed the internal control disclosure index as a proxy for measuring internal control disclosure which is adopted from of Agyei-Mensah [11]. The internal control disclosure index is based on eight items including the internal environment, risk evaluation, control activities, information and communication, internal supervision, internal control defects, internal assessment, and external assessment (see Appendix A.1). Data was manually extracted from annual reports to determine the degree of disclosure for internal control information. The disclosure index captures the existence of internal control information in the annual report.

3.3.3. Ownership Variable

When companies’ owners hold a controlling maximum percentage of the company holdings they are called family-owned companies. In these companies, the top management positions are also held by family members, therefore the corporate governance characteristics and internal control systems are quite different in family-owned companies as compared to other companies [21]. Therefore, three proxies (i.e., family CEO, family-owned firm at 25%, and family owned firm at 50%) are employed to measure the family ownership. Here the family CEO dummy variable is equal to 1 if the business founder or owner or else a heir holds the CEO position and 0 otherwise [14]. The study used two cutoff points 25% and 50% to classify family-owned businesses and non-family owned businesses. The 25% threshold point is recommended by the official definition of the European Group of Owner-Managed and Family Enterprises (EFOMFE), thereby the it is also adopted by the Board of Family business network to classify family and non-family firms. The 50% threshold point is also used because ownership at this percentage level, confers explicit control rights [7].

3.3.4. Control Variable

This study employed five control variables (i.e., firm size, the board size, external auditor size (“Big 4” firms), board independence and audit committee independence) in the regression analysis and their measurement proxies are provided in Table 1. Firm size is considered as an important and fundamental corporate characteristic and it is commonly
estimated that companies with large corporate size have more appropriate internal control quality and have more reliability in financial reporting [44]. With reference to board size, it is suggested that larger boards present great diversity of experience and opinions and increase the ability to monitor and improve internal control quality therefore the size of the board can contribute to the monitoring of the management, resulting in the higher quality of disclosure and reducing the agency cost [45]. It has been proposed that independent auditors act as an external governance mechanism that can play a robust part in a fragile legal environment, as Salehi [46] and Salehi, Saravani and Rouhi [47] suggested that audit quality increases the transparency of accounting and reduces the restatement of financial reporting results. Accordingly, Big 4 auditors will act as a governance substitute for the weak legal protection of outside shareholders as well as strengthen the role played by the audit committee in improving the quality of internal control [48]. Big 4 auditors may enjoy more independence and exert more pressure on management to disclose internal control information [49]. Board independence provides the monitoring role for effective control to mitigate the management self-dealing behavior and this would improve the internal control quality for their effective monitoring role [50,51]. Lastly, the internal audit department plays a crucial role in overseeing and detecting internal control weaknesses and assisting management in improving financial reporting [22]. Audit committee independence reduces the severity and persistence of internal control deficiencies and promotes internal control information in financial reporting [24].

Table 1. Measurement of Variables.

| Variables          | Measurements                                                                 |
|--------------------|------------------------------------------------------------------------------|
| Dependent Variables| • Internal Control Quality                                                    |
|                    | An online survey is conducted among Pakistan auditors to evaluate the firm’s |
|                    | internal control quality (see Appendix A)                                    |
|                    | • Internal Control Disclosure                                                |
|                    | Internal control disclosure index has been used (see Appendix A). Data were  |
|                    | manually extracted from annual reports                                       |
| Independent Variables| • Family Owned Business                                                      |
|                    | Two cutoff point 20% and 50% has been used to classify family-owned businesses|
|                    | • Family CEO                                                                 |
|                    | 1 if the CEO is a business founder, owner or a family member                  |
| Control Variables  | • Board Size                                                                 |
|                    | Number of directors on the board [45].                                       |
|                    | • Firm Size                                                                  |
|                    | Natural logarithm of total assets [44]                                        |
|                    | • Audit Committee Independence                                               |
|                    | Number of independent members divided by total members of the audit committee |
|                    | [22,31]                                                                      |
|                    | • External Auditor                                                           |
|                    | 1 If a firm is audited by Big 4 audit firms otherwise 0 [43,48,49].          |
|                    | • Board Independence                                                         |
|                    | Number of independent board member sitting on board divided by total number   |
|                    | of board [50,51]                                                             |

4. Results and Discussion
4.1. Descriptive Statistics and Correlation Matrix

Table 2 explains the details related to mean, standard deviation and correlation matrix of the variables used in our regression analysis. The descriptive statistics results indicated the average score of internal control quality of Pakistani firms is 2.159 which shows that companies have no intention of focusing on internal control practices and demonstrates the overall weakness of internal control systems in Pakistan. Another dependent variable internal control disclosure (ICD) has a mean of 0.53. As stated by the result, the internal control information disclosure level is not prominent among non-financial companies in
Pakistan. The main variability has been observed in board size as compared to other variables, as its standard deviation is 1.255 with an average of 7.639 board members. The average score of corporate size is 9.70, while the mean value of audit committee independence is 0.3521 with standard deviation of 0.130 as indicate that non-financial firms are inclined to have a low proportion of independent directors on the audit committees in Pakistan. The mean of percentage of independence is 22% with a standard deviation of 11.040, which indicated that non-financial Pakistani firms are most likely to opt for lower board independence. Table 3 illustrates the proportion of dummy variables. First, 51.8% of firms in our sample belong to family firms at the 25% threshold, whereas there are a 49.4% of family-owned firms at the 50% threshold. Besides, it seems that 37.3 percent of CEO of family firms are founders or founder’s descendents and possess ownership power (see Table 3). While 75% of family-owned firms are managed by family CEOs at the 25% threshold level, this value is reduced to 72% if the family holding threshold is increased to a 50% threshold (see Tables 4 and 5). The percentage of external auditor variables shows that 40.9% of companies in our sample are audited by Big 4 audit companies (see Table 3). These results are consistent with the findings of Hussain and Safdar [4], who also reported that there is higher degree of concentrated ownership and controlling shareholders own approximately 87% of firms. The study stated that most of the firms are controlled by families and out of 236 non-financial sample firms, 177 firms belonged to family business groups, thereby these families have also 20% or more top shareholdings in 88.70% of group firms. It is observed that in Pakistan’s family businesses, family members hold top management positions and provide incentives to the dominant shareholders [4].

Table 2. Descriptive Statistics and Correlation.

| Variables | Mean | Std. Dev. | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |
|-----------|------|-----------|---|---|---|---|---|---|---|---|---|----|
| 1. ICQ    | 2.159| 0.557     |   |   |   |   |   |   |   |   |   |    |
| 2. ICD    | 0.530| 0.158     |   |   |   |   |   |   |   |   |   |    |
| 3. 25% FOB| 0.518| 0.503     | −0.081 | −0.076 |   |   |   |   |   |   |   |    |
| 4. 50% FOB| 0.494| 0.503     | −0.082 | −0.076 | 0.953 |   |   |   |   |   |   |    |
| 5. FCEO   | 0.373| 0.487     | −0.088 | −0.074 | 0.745 | 0.782 |   |   |   |   |   |    |
| 6. EXAUD  | 0.410| 0.495     | 0.403  | 0.406  | −0.373 | −0.333 | −0.289 |   |   |   |   |    |
| 7. BSIZE  | 7.639| 1.255     | 0.156  | 0.232  | −0.241 | −0.216 | −0.116 | 0.261 |   |   |   |    |
| 8. FSIZE  | 9.700| 0.838     | 0.311  | 0.324  | −0.174 | −0.124 | −0.252 | 0.458 | 0.356 |   |   |    |
| 9. AINDEP | 0.348| 0.130     | 0.191  | 0.241  | −0.182 | −0.238 | −0.197 | 0.019 | −0.028 | 0.027 |   |    |
| 10. BINDEP| 22.110|11.040   | 0.217  | 0.191  | −0.244 | −0.244 | −0.270 | 0.102 | 0.174 | 0.069 | 0.074 |    |

FOB: Family owned business, FCEO: Family CEO, AINDEP: Audit committee independence, BSIZE: Board size, FSIZE: Firm size, EXAUD: External auditor, DCEO: CEO duality, BINDEP: Board Independence.

Table 3. Proportion for Dummy Variables.

| Variables                        | Percentage |
|----------------------------------|------------|
| Family firms 25% Threshold       | 51.80%     |
| Family firms 50% Threshold       | 49.40%     |
| Family CEO                       | 37.30%     |
| External Auditor Big 4           | 40.90%     |
Table 4. Tabulation of Family Firms (25% cutoff) and Family CEO.

|                | Non-Family CEO | Family CEO | Total |
|----------------|----------------|------------|-------|
| Non-family Firms | 42             | 0          | 42    |
| Family Firms    | 10             | 31         | 41    |
| Total           | 52             | 31         | 83    |

Table 5. Tabulation of Family Firms (50% cutoff) and Family CEO.

|                | Non-Family CEO | Family CEO | Total |
|----------------|----------------|------------|-------|
| Non-family Firms | 40             | 0          | 40    |
| Family Firms    | 12             | 31         | 43    |
| Total           | 52             | 31         | 83    |

In the context of the correlation matrix, the results indicate that the correlation among the independent variables is less than 0.5 except for family firm ownership proxies (i.e., family CEO, family-owned firm at 25%, and family-owned firm at 50%). Therefore, the study constructed three different models for each ownership proxy. These results are consistent with the viewpoint proposed by Oradi, Asiaei and Rezaee [38], who suggested that family-owned firms have a higher tendency of appointing family members to board, management team and CEO positions. Furthermore, the current study has also computed the value of Cronbach’s alpha to measure the internal consistency of the quality of internal controls. Table 6 shows a 0.899 reliability statistic for ICQ, indicating a good internal consistency with respect to internal control quality in Pakistan.

Table 6. Reliability Statistic for Internal Control Quality.

|               | Cronbach’s alpha |
|---------------|------------------|
|               | 0.899            |

4.2. Regression Analysis

The study analyzed the impact of family-owned firms on the internal control quality and internal control disclosure and results are given in Tables 7–10, respectively. Two separate models were employed for ownership proxies (i.e., 25% cut-off point and 50% cut-off point,) for both dependent variables (i.e., internal control quality and internal control disclosure), whereas, the current study also sub-divided the sample into only family firms for the analysis of family CEO impact within the family firms. Therefore, three separate models were constructed based on the sub-sample for family CEO (i.e., full sample, family firms sub-sample at 25% threshold and family firms sub-sample at 50% threshold) for both dependent variables. Hence, in total twelve models were constructed. While column 2 in Tables 7 and 9 represents the models based only on control variables. column 3 and column 4 in Tables 7 and 9 exhibit the results of family ownership proxies for the 25% cut-off point and 50% cut-off point, respectively. Lastly, results with respect to the family CEO full sample and the sub-samples’ models are given in Tables 8 and 10.
Table 7. Internal Control Quality (Family-Owned Business).

|                | Model 1 |                  | Model 2 |                  | Model 3 |                  |
|----------------|---------|------------------|---------|------------------|---------|------------------|
|                | Coef.   | p-Value          | Coef.   | p-Value          | Coef.   | p-Value          |
| 25% FOB        | −0.844 *** | 0.000            |         |                  | −0.871 *** | 0.000            |
| 50% FOB        | 0.313 **  | 0.017            | 0.037   | 0.659            | 0.055   | 0.488            |
| EXAUD          | 0.010    | 0.830            | −0.042  | 0.170            | −0.045  | 0.124            |
| BSIZE          | 0.101    | 0.189            | 0.126   | 0.011            | 0.148 ** | 0.002            |
| FSIZE          | 0.731 *  | 0.089            | 0.180   | 0.508            | −0.034  | 0.898            |
| AINDEP         | 0.008    | 0.107            | 0.002   | 0.644            | 0.001   | 0.693            |
| BINDEP         | 0.595    | 0.414            | 1.633 *** | 0.001         | 1.493 ** | 0.001            |
| Adjusted R²    | 0.211    | 0.689            |         |                  | 0.719   |                  |
| F-statistic    | 4.660 *** | 0.0000           | 26.940 *** | 0.0000       | 31.030 *** | 0.0000            |

*, **, and *** represent significance level at 1%, 5%, and 10%; FOB: Family owned business, AINDEP: Audit committee independence, BSIZE: Board size, FSIZE: Firm size, EXAUD: External auditor, BINDEP: Board Independence.

Table 8. Internal Control Quality (Family CEO).

|                | Model 1 (Total Sample) | Model 2 FOB Sample (Cut-Off 25%) | Model 3 FOB Sample (Cut-Off 50%) |
|----------------|------------------------|----------------------------------|----------------------------------|
|                | Coef.                  | p-Value                          | Coef.                           | p-Value                      | Coef.                           | p-Value                      |
| FCEO           | −0.950 ***             | 0.000                            | −0.582 ***                      | 0.000                        | −0.638 ***                     | 0.000                        |
| EXAUD          | 0.159                  | 0.019                            | 0.185                           | 0.101                        | 0.174                           | 0.118                        |
| BSIZE          | 0.010                  | 0.701                            | −0.143 **                       | 0.012                        | −0.133 **                      | 0.017                        |
| FSIZE          | 0.020                  | 0.620                            | 0.050                           | 0.402                        | 0.030                           | 0.597                        |
| AINDEP         | 0.113                  | 0.612                            | −0.606                          | 0.298                        | −0.432                          | 0.382                        |
| BINDEP         | −0.001                 | 0.388                            | 0.005                           | 0.263                        | 0.004                           | 0.356                        |
| C              | 2.190 ***              | 0.000                            | 2.769 ***                       | 0.000                        | 2.907 ***                      | 0.000                        |
| Adjusted R²    | 0.792                  | 0.589                            | 0.276 **                        | 0.015                        | 0.614                           |                              |
| F-statistic    | 45.470                 | 0.000                            | 40.530                          | 0.000                        |                                |                              |
| Obs            | 83                     | 41                               | 43                              |                              |                                |                              |

**, and *** represent significance level at 5% and 10%, respectively; FCEO: Family CEO, AINDEP: Audit committee independence, BSIZE: Board size, FSIZE: Firm size, EXAUD: External auditor, BINDEP: Board Independence.

Table 9. Internal Control Information Disclosure (Family-Owned Business).

|                | Model 1 |                  | Model 2 |                  | Model 3 |                  |
|----------------|---------|------------------|---------|------------------|---------|------------------|
|                | Coef.   | p-Value          | Coef.   | p-Value          | Coef.   | p-Value          |
| 25% FOB        | −0.211 *** | 0.000            |         |                  | −0.217 *** | 0.000            |
| 50% FOB        | 0.086 **  | 0.018            | 0.017   | 0.522            | 0.022   | 0.400            |
| EXAUD          | 0.014    | 0.290            | 0.001   | 0.905            | 0.001   | 0.956            |
| BSIZE          | 0.026    | 0.225            | 0.032 ** | 0.040       | 0.038 ** | 0.015            |
| FSIZE          | 0.276 **  | 0.023            | 0.139   | 0.117            | 0.086   | 0.322            |
| AINDEP         | 0.001    | 0.234            | 0.003   | 0.987            | 0.004   | 0.964            |
| BINDEP         | 0.012    | 0.952            | 0.272 *  | 0.074       | 0.236   | 0.108            |
| C              | 0.230    | 0.599            | 18.470  | 0.0000           | 20.020  | 0.0000           |
| Adjusted R²    | 5.090    | 0.000            |         |                  |         |                  |
| F-statistic    |         |                  |         |                  |         |                  |

*, **, and *** represent significance level at 5% and 10%, respectively; FOB: Family owned business, AINDEP: Audit committee independence, BSIZE: Board size, FSIZE: Firm size, EXAUD: External auditor, BINDEP: Board Independence.
Table 10. Internal Control Information Disclosure (Family CEO).

|                          | Model 1 (Total Sample) | Model 2 FOB Sample (Cut-Off 25%) | Model 3 FOB Sample (Cut-Off 50%) |
|--------------------------|------------------------|----------------------------------|----------------------------------|
|                          | Coef.                  | p-Value                          | Coef.                            | p-Value                          | Coef.                  | p-Value                          |
| FCEO                     | −0.211 ***             | 0.000                            | −0.116 ***                        | 0.000                            | −0.132 ***              | 0.000                            |
| EXAUD                    | 0.052 *                | 0.055                            | −0.006                            | 0.498                            | −0.008                 | 0.489                            |
| BSIZE                    | 0.014 **               | 0.158                            | −0.002                            | 0.665                            | 0.001                 | 0.844                            |
| FSIZE                    | 0.008                  | 0.613                            | 0.002                             | 0.697                            | −0.004                | 0.493                            |
| AINDEP                   | 0.139                  | 0.123                            | −0.008                            | 0.849                            | −0.021                | 0.690                            |
| BINDEP                   | 0.001                  | 0.675                            | 0.002                             | 0.142                            | 0.004                 | 0.826                            |
| C                        | 0.367 **               | 0.021                            | 0.489 ***                         | 0.000                            | 0.552 ***              | 0.000                            |
| Adjusted R²              | 0.582                  |                                  | 0.868                            |                                  | 0.815                 |                                  |
| F-statistic              | 17.320                 | 0.000                            | 38.710                            | 0.000                            | 27.350 ***             | 0.000                            |
| Obs                      | 83                     |                                  | 41                               |                                  | 43                    |                                  |

*, **, and *** represent significance level at 1%, 5%, and 10%, respectively. FCEO: Family CEO, AINDEP: Audit committee independence, BSIZE: Board size, FSIZE: Firm size, EXAUD: External auditor, BINDEP: Board Independence.

4.2.1. Regression Analysis for Internal Control Quality

Tables 7 and 8 show the regression results for internal control quality related to family ownership proxies and family CEO. The adjusted R² is above 68% for all models except the base model which implies that more than 68% of the changes in internal control quality are explained by independent variables in the five main regression models for internal control quality. The F-statistic probability for the five main regression models of internal control quality is significant with a p-value of (0.000) which implies that the independent variables jointly and significantly explained the dependent variables. The coefficients of regression analysis for internal control quality show that family-owned businesses have a significantly negative impact on internal control quality, while the results for family-owned business proxied through a 25% cut-off point (β = −0.844, and p-value < 1%) and a 50% cut-off point (β = −0.871, and p-value < 1%) indicate that family ownership (i.e., measured at a 25% or 50% cut-off point) has a significant and negative impact on the quality of internal controls, when controlling for the effect of board size, firm size, independent audit committee, board independence, and Big 4 as external auditors. These results imply that family-owned businesses prefer to have weak internal control quality, so that they can enjoy full liberty and control over the financial decisions of firms. In reference to family CEO models, the results exhibit that family CEOs also have a significantly negative impact on the quality of internal controls for both the full sample (β = −0.950, and p-value < 1%) and the sub-samples measured at a 25% threshold (β = −0.582, and p-value < 1%) or a 50% threshold (β = −0.683, and p-value < 1%). These results imply that firms have lower quality of internal controls if it has a family CEO as compared to a non-family CEO and this relationship is further strengthened within family-owned firms which stipulate that family owners coupled with family CEOs would engage in ineffective internal control.

The results of the current study validate the entrenchment effect of family ownership proposed by Bardhan, Lin and Wu [14], Chen, Feng and Li [35], and Zhang and Cao [7]. They suggested that family firms coupled with family CEOs are more likely to have a lower quality of internal controls to serving their own interests which would decrease the likelihood of their future accountability. Empirically, the results of the current study are also aligned with previous studies [14,36] that also described a negative relationship between family ownership and internal control quality.

4.2.2. Regression Analysis for Internal Control Disclosure

Tables 9 and 10 show the results of regression models for internal control disclosure for ownership proxies and family CEO, respectively. The results show that the value of adjusted R² is higher than 59% in all the five main regression models for internal control disclosure which implies that more than 59% of changes in the dependent variable
is explained by the independent variables of the regression models. Furthermore, the independent variables also jointly and significantly explain the dependent variable which is indicated by the 1% significance level of the F-statistics in all five main regression models of internal control information disclosure. The results for internal control disclosure models also exhibit the negative impact of family-owned firms (for both 25% cut off point ($\beta = -0.211$, and $p$-value < 1%) and 50% cut-off point ($\beta = -0.217$, and $p$-value < 1%)) on internal control information disclosure when controlling for the effect of board size, firm size, independent audit committee, board independence and Big 4 as external auditors. These results imply that family-owned business may constrain the quality disclosure of internal controls and have less transparent disclosure of information regarding internal controls in their financial reporting. With reference to family CEO, the results show that a family member CEO also has a significantly negative impact on internal control information disclosure for both full sample ($\beta = -0.211$, and $p$-value < 1%) and sub-samples measured at the 25% threshold ($\beta = -0.116$, and $p$-value < 1%) and 50% threshold ($\beta = -0.132$, and $p$-value < 1%). These results imply that there is less internal control disclosure in firms having family CEOs and even within the family firms, family member CEOs also prefer to have lower internal control disclosure as compared to non-family CEOs, which indicates that family owners employ family CEOs to control the internal control information disclosures. The possible reason in this regard is that firm board member positions and substantial holdings of the company are held by the family and they have easy access to all types of information about the firm so they have less need for disclosure [6]. Moreover, in the family business, family members do not trust public disclosure because they have a direct approach to the company’s internal information, so the accountability of public information is low in family-owned firms. As a result, family owners or family governance has a negative effect on internal control disclosure in financial reporting [35]. Empirically, our results are consistent with the previous literature that also found a negative impact of family ownership [19] and family CEOs [6,52] on internal control information disclosure.

5. Conclusions

In Pakistan, family-owned businesses are prominent in the business community and play a vital part in the advancement of the nation’s economy. Consistent with the argument that family firms are more likely to have a lower quality and disclosure of internal controls [7,14,35], this study finds a significant negative association between family-owned businesses and effectiveness of internal control and disclosure of internal control information. The evidence suggests that a significant amount of family ownership, coupled with the presence of family members as CEO would expose higher agency cost and entrenchment behaviors of owners which would result into ineffective internal control. Hence, it can be concluded that family-owned businesses are interested in maintaining weaker internal controls to extract private benefits from organizational resources. Furthermore, family-owned firms are more likely to hold information related to these ineffective internal controls which would create information asymmetry between family shareholders and non-family shareholders regarding effective utilization of the organization’s resources. These results imply that family-owned businesses exhibit entrenchment behavior because the weak internal controls cannot safeguard against ineffective utilization of organizational financial assets by controlling shareholders and management deficiencies.

The findings of the current study have important theoretical and policy implications, as the results validate the entrenchment behavior of family owners because family owners prefer to have weaker internal controls and family CEOs are used as a mechanism to further reduce the effectiveness of internal controls. Therefore, this study proposes that regulators should employ strict policy initiatives for promoting internal control practices and compel firms to improve and report the internal control information on financial reporting for safeguarding minority shareholder interests. Besides, the findings of the current study encourage focusing on strengthening the management practices and protecting the interests of minority owners; firms must adopt reasonable internal control mechanisms to reduce the
complexities and difficulties of the corporate internal control environment which would prevent the transfer of resources by controlling owners for overall sustainability of any organization.

Despite its contributions and implications, the study is subject to some limitations due to the epidemic situation occurring over a wide area at the time of the data collection. This made it difficult to collect data from the respondents, and as a result the present research is based on an online survey of external auditors. Future research should focus on employing a detailed interview-based approach which would be analyzed through a mixed methodology research design to identify the role of family in the internal control environment to further strengthen the current understanding of family ownership and internal control dynamics.

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Appendix A
Appendix A.1. Index for Internal Quality Disclosure

| Item                        | Content                                                                 | Scores                |
|-----------------------------|-------------------------------------------------------------------------|-----------------------|
| Internal Environment        | Corporate governance structure, human resources policies, corporate culture | Disclosing = 1,      |
|                             | Identification of internal and external risk, risk analysis, risk responses | otherwise = 0         |
| Risk Evaluation             | Internal control activities based on risk Evaluation                     | Disclosing = 1,      |
|                             | The establishment of information and communication system                | otherwise = 0         |
| Control Activities          | Internal supervision from internal audit Department                      | Disclosing = 1,      |
| Information and Communication| The defects or abnormal items in internal control and the improvement methods | otherwise = 0         |
| Internal Supervision        | Assessment from board of directors                                       | Disclosing = 1,      |
| Internal Control Defects    | External auditor’s assessment                                            | otherwise = 0         |

Sources: Agyei-Mensah [11].

Appendix A.2. QUESTIONNAIRE
Appendix A.2.1. Internal Control Quality Checklist

Keeping in view the organization regarding “Control Environment Factor” (CE), Please circle the appropriate response according to the following scale. Questionnaire is adopted from Khlif & Samaha [43].
Table A2. Internal Control Quality Checklist.

| ICQCE1          | Organization Role and Responsibility | 1 | 2 | 3 |
|-----------------|--------------------------------------|---|---|---|
| ICQCE2          | Role of the Board of Director         | 1 | 2 | 3 |
| ICQCE3          | Effectiveness of the Organization and Key Management | 1 | 2 | 3 |
| ICQCE4          | Human Resource policies and procedure  | 1 | 2 | 3 |

Now in answering the following questions focus on organization’s approach towards “Risk Management (RM)” and circle the appropriate choice.

| ICQRM1          | Management Risk Assessment Process   | 1 | 2 | 3 |
| ICQRM2          | Awareness of Compliance with law and regulations | 1 | 2 | 3 |

Again in answering the following questions focus on Organization characteristics of “Overall Monitoring (OM)”. Circle the appropriate response.

| ICQOM1          | Reasonableness of Management’s plans and Budgetary control | 1 | 2 | 3 |
| ICQOM2          | Reliability of Financial reporting and Management’s estimates | 1 | 2 | 3 |
| ICQOM3          | Role of the Audit committee and Internal audit             | 1 | 2 | 3 |

Below are given the statements regarding the “Systems and IT Environment(IT)” of organization. You are requested to respond the relevant choice.

| ICQIT1          | IT functions and Organization                  | 1 | 2 | 3 |
| ICQIT2          | IT strategy                                     | 1 | 2 | 3 |
| ICQIT3          | Management and User Satisfaction                | 1 | 2 | 3 |
| ICQIT4          | IT Organization                                 | 1 | 2 | 3 |
| ICQIT5          | IT People                                       | 1 | 2 | 3 |

Below are given the statements regarding the “System Characteristic(SC)” You are requested to respond the relevant choice.

| ICQSC1          | Technical Architecture                          | 1 | 2 | 3 |
| ICQSC2          | Usage of Emerging Technologies                  | 1 | 2 | 3 |
| ICQSC3          | Key Application background(general accounting)   | 1 | 2 | 3 |
| ICQSC4          | Significant Changes to System and IT environment | 1 | 2 | 3 |
| ICQSC5          | Known Problem with Systems                      | 1 | 2 | 3 |

Below are given the statements regarding the practices of “IT Monitoring Control (MC)” You are requested to respond the relevant choice.

| ICQMC1          | IT Performance Measure                          | 1 | 2 | 3 |
| ICQMC2          | System Development and Implementation            | 1 | 2 | 3 |
| ICQMC3          | Application Maintenance                          | 1 | 2 | 3 |
| ICQMC4          | IT Security                                      | 1 | 2 | 3 |
| ICQMC5          | Computer Operation                               | 1 | 2 | 3 |
| ICQMC6          | Business Continuity and Disaster Recovery Plan   | 1 | 2 | 3 |

Below are given the statements regarding “Internal control Condition (IC)”. You are requested to respond the relevant choice, where 1: Agree 2: Neutral 3: Disagree.

| ICQIC1          | No deviation disclosed in tests of control       | 1 | 2 | 3 |
| ICQIC2          | Control exist: Deviation detected, but unlikely to exceed tolerable rate | 1 | 2 | 3 |
| ICQIC3          | Key control absent                               | 1 | 2 | 3 |
| ICQIC4          | Deviation Detected, but with a high risk of exceeding tolerable rate | 1 | 2 | 3 |
Appendix A.2.2. Demographic Section

Please fill all the relevant values applicable for you.

Gender: [ ] Male [ ] Female

Organization: _____________________________ Email: _____________________________

Date: __________________________

Thank you very much!

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