The Effect of the External System Environment on the Quality of the Company's Internal Control

Jia Xu

Humanity and Social Science Youth Foundation of Ministry of Education of China (11YJC880129)
Projects of the National Social Science Foundation of China (15BGL055)
Dalian Vocational & Technical College 116035

Key words: external system environment; the quality of company's internal control; effect utility

Abstract: Essentially, corporate internal control is a dynamic process to realize the goal of the control of enterprise. Improve the quality of the company's internal control can help companies to grasp the needs of the market development, and reasonably allocate internal resources. This paper analyzed the research results of the quality of internal control of some companies at home and abroad. According to the present situation of the quality of company’s internal control, this paper discusses the effect of the external system environment on the quality of company’s internal control. The conclusion is that good external system environment can contribute to improving the quality of company's internal control. This paper also provide guidance for the improvement of the quality of company’s internal control, and put forward some suggestions for improving the quality of company's internal control from the perspective of the external system environment.

1. The importance of improving the quality of company’s internal control

Internal control is a hot and frontier problem which attracts the attention of domestic and foreign regulatory authorities, practice circle and academic circle in recent years. Essentially, corporate internal control is a dynamic process to realize the goal of the control of enterprise. As a kind of institutional arrangement of the enterprise, corporate internal control is the foundation of the company's internal management. It plays an important role in ensuring the legitimacy and rationality of the management of the company, ensuring the authenticity and integrity of the financial report of the company, and improving the operation efficiency of the company.

In recent years, many financial scandals took place in domestic and foreign enterprises. This phenomenon seriously damaged the interests of the investors, affected the reputation of the enterprise, and disrupted the normal order of the market economy. It is necessary to pay attention to the importance of internal control, and improve the quality of internal control in order to avoid the appearance of financial scandal in large scale. Thus, in 2002, the United States issued the "Sarbanes - Oxley" Act to strengthen the supervision of internal control, which then triggered a global concern on company’s internal control. Shanghai and Shenzhen Stock Exchange respectively issued internal control guidelines in the year 2006 and 2007. National ministries jointly issued the "Basic standard for enterprise internal control" in 2008, and then promulgated the relevant supporting guidelines in 2010. This suggests that promoting the improvement of the internal control of the listed corporation has become a strategic arrangement of the relevant departments and regulatory authorities in China in recent years.

2. Research status of the quality of internal control

2.1 Abroad research status of the quality of internal control

The research on the internal control of enterprises is relatively early in western countries. Internal control in enterprises has becoming a hot topic in the world since the United States issued the "Sarbanes - Oxley" Act to strengthen the supervision of internal control in 2002. Doyle and some other foreign scholars pointed out that enterprises which are small, young, complex, and have bad financial situation will have a low quality of internal control. Goh pointed out that corporate
governance is one of the factors that affect the quality of the company's internal control. Good corporate governance can help companies to make up for the deficiencies in the process of internal control. Ashbaugh-Skaife et al. found that, the perfect degree of internal control in companies that are disclosed the internal control defects is lower than companies that are not disclosed the internal control defects. Cong et al. launched a research on internal control based on American market which has a relatively sound investor protection. The results show that for cross-listed companies, if the investor protection of the motherland is weak, the controlling shareholder is the manager, and the voting right is more than cash flow right, the company is more likely to hide the flaws of internal control after the "Sarbanes - Oxley" Act is carried out.

2.2 Domestic research status

After Shanghai stock exchange and the Shenzhen stock exchange respectively releasing internal control guidance in 2006 and 2007, the internal control problem has gradually become a strategic plan for the long-term development of enterprises. Domestic scholars have also carried out a lot of research, and have obtained relevant theoretical research results. Wu Qiusheng and Yang Ruiping made a research on the evaluation and integration of internal control of the enterprise, and pointed out that the evaluation and integration of internal control can effectively improve the quality of the report of enterprise’s internal control evaluation. Zhao Xi and Su Xiuhua made a research on the relationship between system environment and the operation effect of enterprise’s internal control, and pointed out that the degree of improvement of the system environment has a great effect on the situation of enterprise’s internal control. Liu Qiliang, Luo Yue et al. made a research of the relationship between institutional environment of China's listing Corporation and the company's internal control quality. They found that good external system can contribute to improving the quality of internal control.

2.3 Commentary on the research status

From the analysis of the management of internal control of enterprises in domestic and abroad, we can see that foreign scholars usually do their research on internal control based on American market which has a relatively sound investor protection. They not only made a thorough and systematic discuss about the connotation and content of the internal control, but also pointed out the significance of enterprise’s internal control to the development of the enterprise. It can be seen from the research abroad that the research object is mainly the enterprise of America. Therefore, the conclusion may not be applied to countries with emerging markets. In addition, these studies have neglected the effect of the external system environment on the construction of the internal control of the company. Therefore, the scope of the study of the internal control of the company needs to be enlarged. Domestic scholars draw lessons from the research results of internal control of foreign countries. They classify and analyze the influencing factors, and construct the evaluation index system of the internal control of the company.

On the whole, domestic academic circles have made some achievements in the research of internal control. However, there is still not much research on the relationship between the external system environment and the quality of the internal control of the company. Therefore, it is necessary to further explore the effect between the external system environment and the quality of the internal control of the company. This will have a certain practical guiding significance.

3. Analysis of the effect of the external system environment on the quality of the company’s internal control

In the process of the continuous exploration and research on the internal control of the company, scholars begin to explore the deep factors that affect the internal control of the company. And external system environment is one of the key factors that affect the quality of the company's internal control. In order to establish a sound internal control, the enterprise needs to build a good internal control environment, which is closely related to the external system environment.

External system environment is an important part of the company's internal control environment.
External system environment is the institution and principle of the modern corporation in the aspect of market discipline and government control. It relates to the problem of the allocation of powers and responsibilities, operating efficiency and scientific decision-making among stakeholders. External system environment is one of the important internal management mechanisms of the modern corporation. It plays a vital role in the healthy development of the company. Only a perfect external system environment can really improve the quality of company’s internal control, so that the role of company’s internal control can be effectively played.

The external system environment of the company's development is mainly composed of the marketization process and government intervention. Marketization process refers to the speed of the process of marketization, and government intervention refers to the intervention of local government for market operation.

3.1 Market degree can affect the quality of the company's internal control

In China, the executive power will have a great effect on the operation of companies, especially central enterprises and companies controlled by the local government. However, the external system environment of enterprises will affect company's accounting and financial behavior. Currently, there are obvious differences in the degree of marketization of China's provinces and regions due to historical factors. As companies controlled by the local government are administrated and assessed by local SASAC, the faster the marketization, the more open the government, the better the market competition. Under this circumstance, companies controlled by the government will obtain profit by way of normal operation, control risk, so as to meet the requirements of local SASAC. Therefore, higher degree of marketization can contribute to promoting companies controlled by the government to strengthen the construction of internal control, and improve the quality of internal control.

Companies that are not controlled by the government will also be affected by the process of the regional marketization. The better the system environment of the region where the company is located in, the more orderly the market competition is. These companies are more inclined to develop the company by way of improving the internal control system rather than obtain profits through other means. Therefore, they will actively improve the quality of internal control, so as to form the internal system required by the normal operation of the company.

It can be seen that, in the region of poor marketization degree, executive power will have a great effect on the construction of enterprise’s internal control. Market power will have a relatively small impact on them. On the contrary, in the region of good marketization degree, market power will have a positive effect on the construction of enterprise’s internal control. The effect of executive power will be reduced.

3.2 Government intervention can affect the quality of the company's internal control

In China, the more developed the area, the faster the process of marketization, and the less the government intervention, and the better the market competition. By sorting out the administrative policies of various provinces and cities, it can be found that local government has established a relatively perfect company management policy system in developed area. For instance, in regions such as Pearl River Delta and Yangze River Delta, the role of the government is mainly guide and serviceman, and the government is more enlightened. The purpose of issuing the relevant market management system and policy provision is to promote the rapid marketization and improve the fair competition environment. Enterprises do not need to make much communication with the government to gain profit.

At the same time, in Pearl River Delta and Yangze River Delta, the perfect system environment and enlightened government management make the living environment of the private enterprise much better than heavy industrial areas such as northeast and northwest. And lead to the result that private enterprises account for a relatively large proportion and contributed more than 70% of the local tax. This promotes the rapid change of the transformation of government functions.

However, in the underdeveloped areas, government’s intervention in the market will be more, and market competition is not sufficient. For example, government intervene coal mining in Shanxi
and other places. By limiting the right and the quantity of mining, government can directly intervene the survival and development of an industry. The local coal mining enterprises need to obtain profit by other way.

The quarry industry in Qinling, Shanxi Province and the real estate development industry in the third and fourth line city of northeast are also faced with the side effects of the government intervention. If enterprises of these regions want to obtain production license, they need to spend more time and energy to communicate with the government so as to gain more profit. Accordingly, the internal control of enterprises is existed in name only.

### 3.3 The result of the investigation and research of the listed corporation

This paper takes China’s A share listing corporation from 2010 to 2014 as the research object and makes sample selection at the same time. Eliminate the listed company which miss, do not have or cannot make sure the actual controller; eliminate the corporation which has blurred audit opinion of the quality of internal control; eliminate enterprises whose internal control is missing. And eliminate companies whose financial data are not completely disclosed. Finally, we selected 541 listed corporations that disclosed the audit opinion of the quality of internal control as the research object. We scored the five elements of the company’s internal control. The five elements are internal environment index, internal supervision index, control activity index, risk management index and information management index. Then, weight and averaging the score to get the score of the internal control index of the enterprise. The internal control index of the enterprise is expressed by centesimal system (0-100). The higher the score is, the better the quality of the internal control of the enterprise. The rest related data are mainly from China’s Securities Regulatory Commission, Cninfo and some other related websites. The external system environment index of company’s development is derived from the corresponding year’s “China Market Report (Fan Gang Edition).”

<table>
<thead>
<tr>
<th>Table 1. Results of research and investigation.</th>
</tr>
</thead>
<tbody>
<tr>
<td>External system environment</td>
</tr>
<tr>
<td>Market degree</td>
</tr>
<tr>
<td>Internal environment index score</td>
</tr>
<tr>
<td>Internal supervision index score</td>
</tr>
<tr>
<td>Internal control index of the company</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
</tbody>
</table>

It can be seen from table 1 that the correlation coefficient between the market index and the government intervention index and the five factors of company’s internal control is greater than zero. Thus, we can come to the conclusion that market index and government intervention index have a positive correlation with the five elements of the quality of the internal control of the company. That is to say, the higher the market index, the higher the quality of company’s internal control; the lower the government intervention index, the higher the quality of company’s internal control.

Analyze from the perspective of market index, the effect of the degree of marketization on internal environment, internal supervision, control activities, risk management and information management is different. The degree of marketization has the greatest effect on internal supervision. Followed are the risk management, control activities and the internal environment. The effect on information management is the least.

Analyze from the perspective of government intervention, the effect of the degree of government intervention on internal environment, internal supervision, control activities, risk management and
information management is also different. The effect on control activities is the greatest. Followed are internal supervision, internal environment and information management. The effect on risk management is the least.

4. Enlightenment for the management

According to the result of the empirical analysis and the present situation of the quality of the internal control of China’s listed corporation, enterprises can improve the quality of company’s internal control from the following aspects:

Firstly, improve the quality of company’s internal control from the perspective of thinking of the whole situation. Enterprises need to realize the importance of the quality of internal control for the long-term development of enterprises. Enterprises also need to analyze and think about problems from the perspective of the whole situation and assess the quality of company’s internal control from the five factors including internal environment, internal supervision, control activities, risk management and information management. Companies are supposed to scientifically and reasonably improve the quality of company’s internal control, coordinate the relationship of short-term interest and long-term interest, and explore the development power brought by the improvement of the quality of company’s internal control.

Secondly, grasp the key points. The effect of the two independent variables of market index and government intervention index on the evaluation elements of the quality of company’s internal control is different. For the same dependent variable element, if the independent variable is different, the effect will be different. Therefore, in order to improve the quality of internal control, enterprises must combine the development of their own, find out their deficiency, solve the problem with aim and plan step by step.

References


