Economic Interpretation on the Evolution of Internal Supervision Mechanism

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Abstract. This paper constructs a theoretical framework and deduces mechanism and path in external environment of enterprise, evolution of internal supervision mechanism and individual decision of executive. First of all, Agency Theory is used to explain the root cause of the internal supervision mechanism and inevitability of the supervision of the individual behavior of executives. Secondly, the paper explains the path and motivation of the evolution of internal supervision mechanism by Comparative Institutional Analysis. Finally, Transaction Cost Economics is used to analyze transmission function of internal supervision mechanism evolution between external environment of enterprise and individual behavior of executive, and clarify its mechanism.

1. Introduction

With the expansion of modern company scale economy, the dispersion of ownership, and the refinement of specialized division of labor, managers of company are more likely to extend the control of the company's daily operation and management, so the discussion about "management-control" [1] under the paradigm of two rights separation has become a topic of continuous exploration in the field of corporate governance. Because of the information asymmetry and information cost, the individual contribution in team organization can't be truly measured, then the construction of internal supervision mechanism for the lazy participants becomes the key.

2. Agency Theory as Theoretical Foundation to Analyze Internal Supervision Mechanism

Agency Theory expressed [2] that the conclusion of an express or implied contract clarifies the boundaries of the rights and actions for the participants in the organization, which leads contracting parties to form a principal-agent relationship. But in the case of the principal is difficult to carry out effective supervision, because of some factors, such as incomplete contract, inconsistent objective function of both sides, incentive incompatibility and information asymmetry, make agent pursue his own remuneration maximization out of the principle of maximizing the utility of the principal, which leads to the conflict of interest between the principal and the agent, and then leads to the agency cost. According to Agency Theory, shareholders and managers as contracting parties have realized the incompleteness of contract when signing it, and shareholders expect that company executives have possibility of arbitrariness and rent-seeking behavior, and also foresee agency cost that will occur. In order to reduce the probability of rent-seeking behavior of company managers and prevent loss of value caused by decision deviation because of ownership weakening. Company needs internal supervision mechanism as third party contracting with shareholders supervises
managers. Company's supervision cost increase because of construction and operation of the company's internal supervision mechanism, but the increase of supervision cost balances with the occurrence of residual loss and guarantee cost, which makes the general agent cost lowest, and improves the behavior benefit of company manager's management decision. Finally, maximizes full wealth effect of shareholders on the assumption of agency costs [2].

Therefore, the paper holds that enterprise internal supervision mechanism constructs based on the assumption that company managers deviate from investors' utility, and building supervision mechanism in advance is an important component of constraint and incentive. Internal supervision mechanism is set up according to the practice of Agency Theory in corporate governance. At the same time, Agency Theory is the theoretical cornerstone of explaining the formation of internal supervision mechanism and exercising supervisory power by third party supervisors.

3. Comparative Institutional Analysis to Interpret Evolution of Internal Supervision Mechanism

Internal supervision mechanism of corporate is composed of a series of formal and informal constraints [3], which constrain and regulate the behavior of internal participants of the company; as an institution, it is not inflexible but shows the path of spiral evolution [4].

As an important part of corporate governance mechanisms, internal supervision mechanism is the game equilibrium of exogenous rules and endogenous rules, which is exogenous from the formal and informal rules of political domain, economic exchange domain and social exchange domain, and endogenous from the mandatory legal systems and contract (mainly contracting with shareholders) based corporate governance systems [5]. The endogenous rules of internal supervision mechanism give a set of constraints and incentives of investors and company executives in its domain, as well as a set of technically selectable action rules, where participants act with multiple mutual game selections. One of the results of repeated game is that internal supervision mechanism is effective or ineffective, which affects the innovative participants to start the experimental exploration of new game equilibrium. At the same time, the internal supervision mechanism is not an isolated institutional arrangement, it is in the organizational domain corporate governance system, but also by the political domain, economic exchange domain and social exchange domain and other exogenous game rules displacement trajectory. The change of technology, resource endowment and other parameter sets in the external environment will affect the game players (mainly including investors and company executives) inferring, expecting and making decisions in organization domain. Therefore, exogenous game rules affect the self-implementation of internal supervision mechanism. According to the framework of system evolution, the participants (investors) can infer potential rent-seeking behavior of company executives for their own benefit. On the basis of the fixed and objective cognition of all possible actions about existing internal supervision system, some companies with spirit of strategic innovation or change can expect the better equilibrium of the supervisory effectiveness of internal supervision mechanism to form a self-implementation mechanism, by deducing or drawing on the practical experience of the diachronic evolution of corporate governance supervision mechanism in advanced countries, which can actively promote the emergence of a new equilibrium point of the internal supervision mechanism.
4. Transaction Cost Economics to Construct Hierarchical Framework for Internal Supervision Mechanism

Transaction Cost Economics proposes a three-level framework model with governance of organizational contractual relationship as core[6], and holds that organizational governance is both accommodated by objective institutional environment and more microscopic individual characteristics. On one hand, the change of institutional environment is regarded as displacement parameter, which determines the change of game rules such as property right, law and custom, then leads to the change of comparative cost of economic organization governance. At the same time, individuals take the behavior hypothesis of endogenous preference as starting point, and individual behavior attribute will lead to the change of governance comparative cost, so organizations with self-life may promote organizational restructuring or innovative governance mechanisms [6]. On the other hand, in turn, the governance structure of adaptive selection as an intermediate level has implications for the institutional environment and individual actors. The strategic adjustment of organizational governance structure will change with institutional background and promote institutional evolution, moreover, the construction of governance structure to organization's subsets or behavior individuals have the role of restriction and incentive. Thus, the evolution of governance mechanism achieves direct and visible benefits, and unexpected gains are enhanced after deducting unnecessary costs.

The macro-environment of each country or region, such as the legal environment, the government behavior environment, the financial environment, the product market competition environment and the cultural environment, all have differences, This provides an opportunity for some organizations to innovate internal oversight mechanisms, adapt to changes in environmental parameters or differences, and then implement Voluntary governance mechanisms. Based on the idea of three-tier framework of transaction cost economics, internal supervision mechanism at intermediate level is the governance mechanism emphasized and concerned by transaction cost economics, which core is adaptation[7]. Changes or differences in external environment of enterprises as displacement parameters will lead compare transaction costs in internal supervision mechanism of different companies alter. Under uncertain conditions, executives who will fulfill the imperfect contract with rational intention but limited cognition may act opportunistically afterwards. To prevent opportunistic risk, Extending profit margin between current or potential gains and transaction costs, A game among the internal traders of company will make the internal supervision mechanism coordinate and adapt [7].

Internal supervision mechanisms are empowered by legal rules and contracting with shareholders for financial and operational oversights. The internal supervision mechanism realizes the essence of participation mechanism through spontaneous adaptation and coordinated adaptation[8,9], while the adaptive institution of innovated makes supervision function and balance function of the internal supervision mechanism play more fully, which can further deepen supervision to reduce the risk of company's executive deviance. In summary, this paper holds that internal supervision mechanism, as an intermediate-level medium, plays a conductive role, which transmits incentive effects and constraint effects of exogenous rules in institutional environment from top to bottom (individual participants). Thus, a cross-level causal relationship in "external environment of enterprise—evolution of internal supervision mechanism—decision-making of individual (executive)", which is the main argument of this paper is in line with three-level framework of Transaction Cost Economics.
References


