

Research on the Effect of Corporate Governance Characteristics over the Remediation of Internal Control Weaknesses

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Abstract: The phenomenon of company bankruptcy or financial fraud caused by internal control defects frequently occurs in companies. The paper analyzes the characteristic of corporate governance on internal control defect, based on the principal-agent theory, rational economic man hypothesis, signaling theory ect. The results show that the characteristics of corporate governance have a positive impact on the repair of internal control defects.

1. Introduction

At present, China is in the early stage of the construction of internal control laws and regulations, and the identification of internal control defects is still unclear. From the perspective of corporate governance, this paper studies the influence of corporate governance characteristics on internal control defect repair, in order to find corporate governance characteristics conducive to internal control defect repair and achieve effective internal control.

2. Literature Review and Research Hypotheses

2.1. Research Hypothesis

The board of directors is at the core position of the modern corporate governance structure. Therefore, this paper proposes the following hypotheses:

(1) **The size of the board of directors.** The size of the board of directors has an impact on decision-making efficiency and supervision efficiency, but this impact is not linear. Therefore, hypothesis 1 was proposed: other things being equal, the size of the board of directors has an inverted u-shaped relationship with the possibility of internal control defect repair.

(2) **Independence of the board of directors.** The independence of the board of directors mainly refers to the proportion of independent directors among board members and whether the CEO and the chairman are the same. Based on this, hypothesis 2 is put forward: the higher the proportion of independent directors is, the greater the possibility of internal control defect repair is, under the condition that other conditions remain unchanged.

(3) **The diligence of the board of directors.** The diligence of directors is reflected mainly through the meeting times of the board of directors. Therefore, the following hypothesis 3 is put forward: the more diligent the board of directors is, the greater the possibility of internal control defect repair is, other things being equal.

(4) **Whether there is an audit committee.** The audit committee is a key institutional arrangement in the corporate governance structure. Therefore, hypothesis 4 is that: the larger the size of the audit committee is, the greater the possibility of internal control defect repair is under the condition of other conditions remaining unchanged.

(5) **The shareholding ratio of managers.** Management shareholding is an important method to solve agency conflicts. Therefore, hypothesis 5 is proposed: under the condition of other conditions

remaining unchanged, the higher the management shareholding ratio is, the greater the possibility of internal control defect repair is.

2.2. Definition and Measurement of Variables

Table.1. Variable names and definitions

Types of variables	Name	Definition	Symbol
Explained variable	Internal control of the effect of major defect repair	If the internal control defect is repaired, take 1 if it has been repaired or partially repaired; otherwise, take 0	REMEDiate
	Board size	Number of board members	BDsize
Explanatory variables	Independent directors proportion	Number of independent directors/board of directors	Ddb
	Diligence of board of directors	Number of board meetings in an accounting year	Dmeetings
	Audit committee characteristic	Whether there is an audit committee	Asize
	Equity characteristic	Management shareholding	Ms
	The company size	In terms of the natural logarithm of the company's assets	Size
Control variables	Cash flow from operating activities	Cash flow from operating activities of the company	Ocf
	The return on assets of the company	Represents the profitability of the company	Roa
	Quick ratio	Quick assets/current liabilities	Sud
	Fixed number of year of the listed	The number of years it took the company to go public by the end of year	Year
	Executive compensation	Compensation for top three executives	Xinc
	Inventory	Inventory/total assets	Cunh

This paper studies the influence of corporate governance characteristics on internal control defect repair, and this paper takes the characteristics of corporate governance as explanatory variables, the control variables are mainly the operating variables of the company. Specific variables are shown:

2.3. Establishment of Research Model

According to the above assumptions and variables, the multiple regression models are constructed as follows.

$$\begin{aligned} \text{Logit}[\text{REMEDiate}] &= a + b_i \sum_{n=1}^n (\text{corporategovernance}) + b_d * (\text{BDsize})^2 + C_i \\ &+ \sum_{n=1}^n \text{Control variables} + \varepsilon \end{aligned}$$

Where, a is a constant, b_i is the coefficient of each explanatory variable, b_j is the coefficient of each interaction term, C_i is the coefficient of each control variable, b_d is the coefficient of each quadratic term, and ε is the random error term.

2.4. Sample Selection and Data Sources

In this paper, the A-Share market listed companies in Shanghai and Shenzhen from 2015 to 2017 were selected as samples to observe whether these companies would fix the defects in the following year after the occurrence of internal control defects.

3. 3. Regression Results and Analysis

In this paper, Logit regression model was used to conduct an empirical analysis on the relationship between characteristic variables of corporate governance and internal control defect repair. The regression results are shown in table 2.

(1) **The board size.** Board size and defect repair of internal control presents a u-shaped relationship, board size square coefficient is 1.022, shows that with the increase of scale of the board of directors, the possibility of internal control defect fix increased, assuming that (1) is not supported by empirical evidence, however, the test of board size passed the significance test.

(2) **The proportion of independent directors.** Hypothesis 2 has passed the test. In terms of board independence, the proportion of independent directors is positively correlated with the internal control defect repair and it is significant.

(3) **The diligence.** Hypothesis 3 has passed the significance test, indicating that the higher the frequency of the board of directors' meetings, the more likely it is to discuss with the management about how to fix the defects of internal control.

(4) **Whether to set up an audit committee.** Hypothesis 5 has passed the significance test, indicating that the establishment of an audit committee within the company can play a supervisory role in the internal control defects of the enterprise.

(5) **Management shareholding.** Hypothesis 6 didn't pass the test, shows that the management through the equity incentive didn't have a positive impact, these reflects the lack of motivation in listed companies.

Table.2. Regression results of the influence of corporate governance characteristics on internal control defect repair

Variable	Symbols to predict	Coefficient
Dsize^2	-	1.022(0.442)
Dsize	+	0.395(0.001)
DJren	-	0.434(0.133)
Ddb	-	17.720(0.000)
Dmeetings	+	0.096(0.014)
Ls	+	0.001(0.924)
Xinc	+	0.001(0.730)
Size	+	0.001(0.781)
Ocf	+	0.001(0.081)
Cunh	+	0.001(0.777)
Roa	-	2.055(0.060)
Sud	-	0.021(0.826)
Year	+	0.019(0.442)
	AdjR-squared	0.147
	Total sample	2811

4. Conclusion

First, from the overall point of view, the management's own attention and willingness to internal control defects and the pressure that corporate governance factors can exert on the management are the key factors affecting the repair of internal control defects. Second, the board of directors has some influence on the repair of internal control defects. Third, the audit committee in the internal control defect repair role is reflected and that is a significant positive correlation. Fourth, the management shareholding ratio of the listed company internal control defect repair effect is not significant.

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