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Employee quality, monitoring environment and internal control

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ABSTRACT

We investigate the effect of internal control employees (ICEs) on internal control quality. Using special survey data from Chinese listed firms, we find that ICE quality has a significant positive influence on internal control quality. We examine the effect of monitoring on this result and find that the effect is more pronounced for firms with strict monitoring environments, especially when the firms implement the Chinese internal control regulation system (CSOX), have higher institutional ownership or attach greater importance to internal control. Our findings suggest that ICEs play an important role in the design and implementation of internal control systems. Our study should be of interest to both top managers who wish to improve corporate internal control quality and regulators who wish to understand the mechanisms of internal control monitoring.

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1. Introduction

With the advent of the knowledge economy, human capital rather than physical assets has become the essential strategic resource of businesses. Rajan and Zingales (1998, 2000) have formalized the human capital theory of corporate governance. They argue that governance problems are no longer concentrated at the top of a steep pyramid; the focus of corporate governance in the new millennium must shift to the governance problems of employees. However, previous studies provide limited evidence of the extent to which employees influence corporate actions. In this study, we focus on internal control because internal control is a core component of corporate activities and is thus suitable for assuring the achievement of objectives relating to

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operations, reporting and compliance (COSO, 2013). We contribute to the literature on internal control by examining the relationship between internal control employees (ICEs) and internal control quality, and the effect of monitoring on this relationship.

Specifically, we ask two complementary research questions. Our first question examines whether ICE quality influences internal control quality. We argue that high quality ICEs increase the human capital investments in the design and implementation of internal control process, and thus improve internal control quality.

Our second question examines whether the monitoring environment modifies the effect of ICE quality on internal control quality. Although we predict that ICE quality has a positive influence on internal control quality, it is possible that this influence may vary between firms that are stringently monitored and firms that are not stringently monitored by regulators, institutional investors and/or top managers. Stringent monitoring could alleviate the employee agency problem and provide ICEs with incentives not to shirk. The increased diligence of employees further promotes the positive effects of ICE quality. Therefore, we expect that the positive effect of ICE quality on internal control quality is more pronounced in firms that are subject to more stringent monitoring.

Using special survey data from Chinese listed firms, we study a sample of 1522 firm-year observations from the 2011 to 2013 period. We use number, education and job tenure as the quality attributes of ICEs, and find that high quality ICEs improve internal control quality. Further, we examine the effect of monitoring on this relationship, and find that the positive effect of ICE quality is more pronounced for firms in stringent monitoring environments. In particular, we find that the positive effect is more significant when firms implement the Chinese internal control regulation system (CSOX), have higher institutional ownership or attach greater importance to internal control. Our results are robust to the misreporting problem of internal control weaknesses, endogeneity bias and chairman turnover.

Our study contributes to two streams of research. Our first contribution was to the internal control literature. To the best of our knowledge, this is the first study to demonstrate the influence of ICEs on internal control quality. There is a large and growing literature examining the determinants of internal control quality (e.g., Doyle et al., 2007; Ashbaugh-Skaife et al., 2007; Hoitash et al., 2009), but no study has examined the influence of ICEs. Given the increased importance of human capital in effective internal control (Doyle et al., 2007), we use special survey data from Chinese listed firms to examine how ICEs influence internal control quality. Our findings suggest that high quality ICEs are more likely to effectively discharge their responsibilities, thus increasing internal control quality.

Our second contribution was to the literature on the employee agency problem. To our knowledge, prior research has not examined the effect of monitoring mechanisms on the employee agency problem. We help fill this gap by providing the first evidence of the effect of monitoring on the relationship between ICEs and internal control quality. Our results suggest that monitoring by regulators, institutional investors and/or top managers could alleviate the employee agency problem and improve the positive effect of ICE quality.

The rest of this paper proceeds as follows. Section 2 introduces the institutional background and reviews related studies. Section 3 provides theoretical analysis and hypothesis development. Section 4 describes the research design, Sections 5 and 6 report the empirical results and robustness tests, respectively, and Section 7 concludes the paper.

2. Institutional background and literature review

2.1. Institutional background

In recent years, Chinese regulators have issued a series of internal control regulations. In May 2008, the five ministries, including the Ministry of Finance (MOF) and China Securities Regulatory Commission (CSRC), jointly issued the Basic Standards of Enterprise Internal Control (hereafter, the Basic Standards). In April 2010, the five ministries jointly issued a series of internal control guidelines, including the Implementation Guidelines for Enterprise Internal Control, the Guidelines for Assessment of Enterprise Internal Control and the Guidelines for Audit of Enterprise Internal Control. The Basic Standards and these guidelines constitute the internal control regulation system in China, which is also called CSOX.

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