



Factors Affecting the Effectiveness of Internal Control in Chinese SMEs

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Abstract: SMEs represent economic vitality and can reflect the degree of development of a country's economy; the more developed the economy, the greater the number of SMEs. However, the survival environment of SMEs is complicated, resulting in short life cycle and weak risk resistance. Fortunately, China's SME business environment is getting better and better. At this time, if SMEs want to survive in the competition and develop in the survival, they just need to improve their own business management and risk prevention ability. And internal control is one of the important management tools and functions to enhance market competitiveness.

Internal control for SMEs is equivalent to capillaries for people. Any organ or part of a human being is covered with capillaries, and internal control is also ubiquitous throughout the entire life cycle of SMEs, covering and soaking in all aspects, whether at the strategic level, or at the business level; at the financial level or at the management level; at the start-up stage, or at the growth, maturity and transformation stages; at the governance level, or at the management and business levels; at the sales department, or at the production department; all have internal control. Therefore, internal control in SMEs is no longer a multiple choice question of whether to design and implement, but a must-answer question of how to reasonably design and effectively implement.

High quality internal control is not something that can be achieved overnight, nor is it something that is set in stone. In other words, the design and implementation of internal control is a dynamic process of change. The demand and supply factors for internal controls in economic activities and business management are not static, but are constantly changing, and these changes, in turn, often require changes in internal controls. Moreover, internal controls should not be passively accepted, but actively created according to the needs. The question discussed in this study is: What are the practical difficulties in establishing an effective internal control system in SMEs? Based on Maslow's Hierarchy of Needs Theory and Demand and Supply Theory, and using the interview method, this study interviewed managers of 32 SMEs in China from their business objectives to the five elements of internal control, using the SPADER (Situation, Problem, Alternative, Decision, Executive, Review.) and PDCA (Plan, Do, Check and Act) cycles in operations management and quality management as research ideas. And found that currently all Chinese SME owners have recognized the necessity and importance of internal control to varying degrees, but firstly, they do not know how to do it, secondly, there is not sufficient urgency, and thirdly, it is difficult to realize systematically, in addition, due to financial and capacity constraints, they are not in a condition to give the corresponding resource allocation and investment.

Keywords: SMEs, Internal control, Interview, risk prevention, Maslow's hierarchy of needs theory, demand & supply theory

Introduction

In 2004, after the outbreak of the financial frauds of China Yinguangxia and Lantian, China also began to institutionalize the requirements for modern enterprise internal control. In May 2008, "in order to strengthen and standardize enterprise internal control, improve the level of enterprise management and risk prevention, promote sustainable development of enterprises, and safeguard the order of the socialist market economy and the interests of the public, the Ministry of Finance of the People's Republic of China, together with the Securities Regulatory Commission, the Audit Commission, the Banking Regulatory Commission and the Insurance Regulatory Commission, formulated the Basic Standard for Enterprise Internal Control" (Finance and Accounting [2008] No. 7), which is known as the Sarbanes-Oxley Act of China. Article 2 of the Code states, " this Code is applicable to large and medium-sized enterprises established in the People's Republic of China, and small enterprises and other units may establish and implement internal control with reference to this Code" (Basic Standard for Enterprise Internal Control, 2008). In 2010, supporting guidelines were issued, namely the Guidelines on the Application of Enterprise Internal Control, the Guidelines on the Evaluation of Enterprise Internal Control and the Guidelines on the Audit of Enterprise Internal Control. Since then, the construction of internal control in large and medium-sized enterprises has entered the fast track. In order to implement the relevant requirements of the Party Central Committee and the State Council on 'stabilizing growth, promoting reform, adjusting structure, benefiting people's livelihood and preventing risks', guiding and promoting small enterprises to strengthen internal control construction, improve management and risk prevention ability, and promote the healthy and sustainable development of small enterprises, the Ministry of Finance of the



People's Republic of China has formulated the Standard on Internal Control for Small Enterprises (for Trial Implementation)" (Finance and Accounting [2017] No. 21), which has come into effect since January 1, 2018. As of that time, all Chinese small, medium and large enterprises had internal control norms.

The Basic Standard for Enterprise Internal Control and the Standard on Internal Control for Small Enterprises (for Trial Implementation) define internal control in basically the same way, i.e., the process implemented by the board of directors, supervisory board, managerial level (or the person in charge of the small business) and all employees of the enterprise and aimed at achieving control objectives. However, the objectives are slightly different, as shown in Table 1.

Table 1. Comparison of internal control objectives of different Standard in China

The Basic Standard for Enterprise Internal Control	The Standard on Internal Control for Small Enterprises (for Trial Implementation)
Reasonable assurance	Reasonable assurance
(1) Lawful and compliant business management; (2) Safety of assets; (3) Truthfulness and completeness of financial reports and related information; (4) Improving operational efficiency and effectiveness; (5) Promoting enterprises to achieve their development strategies.	(1) Legal compliance of small business operation and management; (2) Safety of financial assets; (3) Truthful and complete and reliable financial reporting information.

SMEs are a critical presence in economies around the world. China's State Council conducted the Fourth National Economic Census in 2017-2020. the statistical results show that the number of legal entities grouped by region and unit size totaled 18,234,939. Among them, the number of SMEs accounts for 99.82% of the total number of enterprises in China (Table 2), which is the largest number of enterprises and the most innovative and dynamic group.

Table 2. Statistics on the number of enterprise entities grouped by unit size in China(2020)

Region	Number of legal person units (pcs)	Large	Medium	Small	Micro
National	18234939	32255	241620	2399010	15562054
Ratio	100%	0.18%	1.33%	13.16%	85.34%
Total : 99.82%					

(Note: This table does not include the data of units without unit size identification)

The Chinese government pays great attention to the development of SMEs. President Xi Jinping stressed that SMEs are connected to thousands of households and are an important force in promoting innovation, employment and improving people's livelihood. Employment is the foundation of people's livelihood, and China will have more than 11 million college graduates in 2023, and the fundamental way to solve employment is to develop the economy, and private enterprises are the manifestation of economic development vitality, and the vast majority of private industry enterprises are SMEs, which contribute 80% of urban employment in China (Table 3).

Table 3 Statistics on the number of employees of enterprise entities grouped by unit size in China

Region	Total number of employees (person)	Large	Medium	Small	Micro
National	294689977	60814250	67788879	99408217	66678631
Ratio		20.64%	23.00%	33.73%	22.63%
Total: 79.36%					

(Note: This table does not include the data of units without unit size identification)

Therefore, "promoting the development of SMEs is a long-term development strategy for China" (Li Qiang, Premier of the State Council of China, 2023).

The rest of the paper is organized as follows: The first part is a brief literature review about the factors affecting the effectiveness of internal control. The second part is theoretical basis. Then the methodology that used to gather and process information about the factors affecting the effectiveness of internal control of the small and medium Enterprises in China. Next are the main results we have obtained. The last is the conclusion.

Literature Review

Factors affecting the effectiveness of internal control include external and internal factors, among which external factors are mainly laws and regulations and external supervision etc. Internal factors specifically include:

1. Corporate culture.

Many scholars have found that the awareness and knowledge of internal control at the top level, including the chairman, general manager and other key corporate leaders, the moral values, business theory, leadership style, competence, sense of purpose, team consciousness, and attitude toward risk at the top level can have an impact on internal control

(Pfister, 2011; Cheng Xiaoling, Wang Huai-ming, 2008; Zheng Shiqiao, 2009; Zhang Jide et al, 2013; Wu Qiusheng et al, 2015; Tang Xiaojian, Du Dongying, 2017).

2. Firm size.

The study found that firm size affects internal control. Compared with other companies in the same industry, companies that experienced internal control deficiencies were smaller. The smaller the size of the company, the greater the likelihood of internal control deficiencies. Compared to smaller companies, larger companies have better implementation of internal accounting controls (Bryan, Lilien, 2005; Doyle et al, 2007; Rongen Zhu et al, 2004; Ying Zhang, Hongtao Zheng, 2010).

3. Financial status.

Generally speaking, the better the financial status of a company, the more it focuses on the construction of internal control, the more it invests in internal control funds and resources, and the more effective the internal control is (Ge, Mcvay, 2005; Bryan, Lilien, 2005; Doyle et al, 2007; Garg, 2018; Zhang, Ying, Zheng, Hongtao, 2010).

4. Life cycle in which it is located.

According to the enterprise life cycle theory, the development stages of enterprises can be divided into: start-up, growth, maturity and metamorphosis. At different stages, enterprises face different internal and external environments, different goals and different risks, then the need for internal control is also different. It is found that the younger the company is, the weaker the internal control is; while the company in the growth stage, especially in the maturity stage, have more stable operations, have a stronger need for internal control, and pay more attention to the construction of internal control (Doyle et al., 2006; Zheng Shiqiao et al., 2009; Li Daijun, 2013).

In the perspective of empirical research, some scholars use internal control deficiencies or disclosure of internal control assurance reports by companies as a proxy for measuring internal control effectiveness (Doyle et al, 2007; Fang Hongxing, Jin Yuna, 2011; Xiao Hua, Zhang Guoqing, 2013). Some scholars create risk management index, national internal control index, and internal control disclosure index (Tseng, 2007; Moerland, 2007; Yang Yufeng, Wang Huoxin, 2010). Some scholars used AHP fuzzy evaluation method to construct progressive hierarchical index system (Han Chuanmo, 2009). Yang Jie (2011) combined the PDCA cycle theory of quality engineering. Fang Hongxing, Liu Dan (2013) relied on principal component analysis to measure the degree of achievement of the five objectives of internal control. Zhang Xiaolan et al. (2012) and Wang Chen Yan et al. (2014) used entropy model to calculate internal control effectiveness index. Zhang Yazhou (2021) used the cluster G1-variance coefficient method to determine the subjective and objective weights of each evaluation index, and used the ideal solution method for combination weighting to construct an internal control effectiveness evaluation index system.

Theoretical basis

Theoretical foundation is the cornerstone of research. Different research perspectives are supported by their own theoretical foundations. Because many SME owners are mostly entrepreneurs, the considerations are largely from the perspective of individual natural persons and based on the actual needs of internal control of SMEs. Therefore, one of the theoretical foundations of this study is Maslow's hierarchy of needs theory. The internal and external environment works together to promote the establishment and improvement of internal control. But what is more important is the internal demand, which is the internal factor, because the internal factor determines the external factor and the external factor works through the internal factor. Therefore, the second theoretical foundation of this study is the theory of demand and supply. This is one of the major innovations of this study. Using these two theories as the basis for conducting research on the effectiveness of internal control in SMEs will help to better understand its problems and also help to propose constructive countermeasures.

1. Maslow's Hierarchy of Needs Theory

In 1943, Abraham H. Maslow (1908- 1970) proposed Maslow's Hierarchy of Needs theory, and in 1954, in his book *Motivation and Personality*, he pointed out that the basic needs of human beings, like a pyramid, from low to high, are physiological needs, security needs, belonging and love needs, respect needs, and self-actualization needs in order. After the basic needs are satisfied, a subject will have higher needs. The realization of each level of needs is a condition for reaching the higher level of needs. When faced with multiple needs, the lowest level needs are often the first to be satisfied. For SMEs, the most basic need is to ensure survival, and when survival is still difficult, its need for internal control is limited, or temporarily unable to take into account, or in the short term, it is better to have internal control, but it does not matter if there is no internal control. Only after ensuring survival, it has the spare capacity to establish internal control. This is in line with Maslow's hierarchy of needs theory. Therefore, for SMEs, internal control is an "Adding flowers to the cake" rather than a "Sending charcoal in the snow".

2. Demand and Supply Theory

Li Wei and Yang Ying (2008) studied the demand for an effective internal control system from the external environment such as macro environment changes, theory development, policy and regulation changes, and the construction of a harmonious society. This study finds that external regulation does lead to the construction and improvement of internal control. However, what plays a fundamental and decisive role and can really drive the continuous improvement of internal control is the internal motivation and demand, which is the difference between "asking me to control" and "I want to control". Only when an enterprise has a demand for internal control will it take

the initiative to study internal control and become interested in internal control, and it will naturally allocate its limited resources to internal control in a highly efficient manner. This is especially true in the era of digital intelligence. There is an old Chinese saying: "Nothing forcibly done is going to be agreeable" and "Interest is the best teacher".

3. PDCA Cycle

The PDCA Cycle in quality management was developed by Dr. W. Edwards Deming and its objective is to significantly improve the effectiveness of a business or organization, The process includes Plan, Do, Check and Act. The working principle is in accordance with the PDCA cycle, week after week, continuous cycle, the previous cycle is the basis of the next cycle, pick up the steps, continuous improvement. It believes that "only in the endless cycle of continuous discovery and problem solving is it possible for the object of study to be improved. And the internal control of the enterprise also needs such a step-by-step process" (Yang, J., 2011). Planning is the design of internal control, Do is the key link to turn "internal control on paper" into "internal control in action", check is to identify the defects in design and operation, and act is to rectify. In addition, "the PDCA cycle theory, each cycle is a large ring set of small rings, one ring is connected to another, mutual constraints and complement each other, the upper cycle is the basis for the next cycle, the next cycle is the implementation and specification of the previous cycle, each cycle covers the feed-forward control, simultaneous control and feedback control three links" (Yang Jie, 2011).

Generally speaking, it is difficult to determine what kind of internal control is needed at the beginning, and it can only be standardized gradually by giving necessary corrections to the problems found during the actual implementation. This is in line with the principle of PDCA cycle.

Research Methodology

1. Research design

This study combines theory and practice, based on existing literature, and is conducted in the form of interviews, which are mainly conducted by telephone, WeChat, Tencent QQ and Email. In addition, the SPADER (Situation, Problem, Alternative, Decision, Executive, Review) problem analysis method in operation management and the PDCA (Plan, Do, Check and Act.) Cycle in quality management are combined to provide new ideas for studying the internal control of SMEs. As shown in Figure 1.SPADER specifically refers to Situation, Problem, Alternative, Decision, Executive and Review. PDCA specifically refers to Plan, Do, Check and Act.

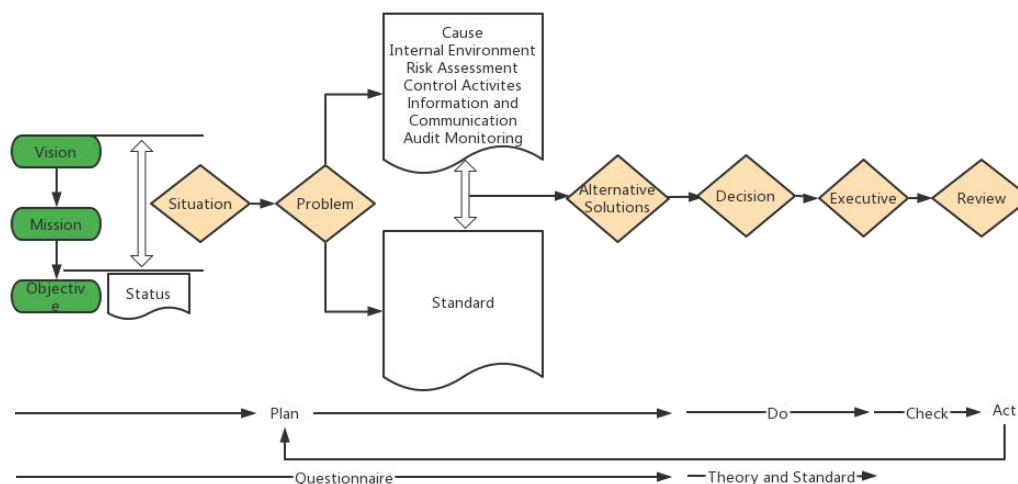


Figure 1. Research Idea Map
Source: By Researcher

2. Interview outline

The content of the interview with the respondents was adjusted according to the situation, mainly including the following aspects:

- (1) Basic information such as the size of the company, its business philosophy, business objectives, and the environment it faces for survival and development.
- (2) The importance of internal control to the survival and development of the enterprise.
- (3) The current status of the enterprise's internal control.
- (4) The main problems and difficulties encountered in the process of constructing internal control.
- (5) The realization of various national preferential policies.
- (6) Expectation on the policies and the future direction of action of the enterprise.

3. Respondents of Interviews

A total of 32 managers of MSMEs in China were interviewed in this study. These MSMEs were mainly from five sources: the researcher's classmates in high school, college, and graduate school who worked in MSMEs or started

their own businesses, relatives and friends, school-enterprise partners in the integration of industry and education, members of internal control QQ groups joined during the research process, and the database of the national public service demonstration platform for SMEs on the website of the Chinese Ministry of Industry and Information Technology. The distribution of the sample is shown in Table 4.

Table 4. Sample Distribution

Gender	Number of persons	proportion
Male	13	39.39%
Female	20	60.61%
Total	33	100%

Respondents were 82% aged 32-44 years old. 67% had a bachelor's degree and 24% had a master's degree. The percentage of those whose major is business is 70%. The interviewed companies were not involved in the electricity, heat, gas and water production and supply industry and the water, environment and public facilities management industry. The specific situation is shown in Figure 2.

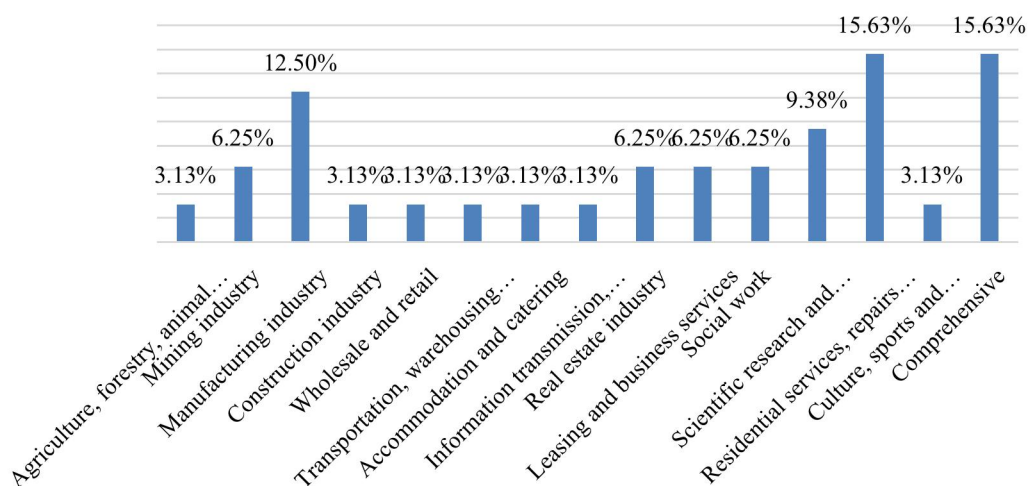


Figure 2. Statistical chart of industries covered by the interviewed companies
Source: By Researcher

Research Results

Based on the interviews, the following meaningful findings were obtained.

1. Content of internal control in SMEs

For SMEs, their internal controls can be divided into two parts, which are named as "necessary internal controls" and "optional internal controls" in this study.

Among them, "necessary internal controls" refers to the internal controls that are designed and implemented according to the actual needs of SMEs, including budget management, management processes, business processes, reimbursement processes, financial systems, and external audits by a third party at least once a year, which are also described as "essential internal controls", "offer fuel in snowy weather-timely internal control" or "mandatory internal control" in this study. In addition, the remaining internal controls, i.e., "optional internal controls", are also referred to as "add flowers to embroidery internal control—embellish what is already beautiful" or "encouraged internal controls" in this study.

2. Requirements for internal control of SMEs

As the name implies, "necessary internal control" is a red line and a bottom line that enterprises must achieve and adhere to, otherwise they will be at risk of survival; while "optional internal control" can be increased or decreased, allowing enterprises to make their own judgments and decisions, taking into account their own capabilities, capital and resources etc. For SMEs, it is not easy to ensure that "necessary internal controls" are in place. Therefore, this study emphasizes that the study of internal control in SMEs should focus on "necessary internal control".

3. Analysis of the factors affecting the effectiveness of internal control in SMEs and the causes

The study found that there are two main factors affecting the effectiveness of internal control, one is the components of internal control, especially the internal environment, including the national policy tendency and the attitude, awareness and importance of internal control of SME owners, etc. The state has issued many preferential policies for SMEs, but on the one hand, they have to be further implemented through local communities, and on the other hand, SMEs do not enjoy the policies due to imperfect internal control; and control activities, compared with the control environment, SMEs are more concerned about the implementation of specific, independent control activities, more concerned about

"how to do", while ignoring the overall effectiveness of internal control $1+1>2$. The other is the characteristics of the enterprise itself, including its size, financial status and life cycle.

In view of this, it is difficult to ask SMEs to make internal control as comprehensive and detailed as a system as large enterprises do. Specific reasons include:

(1) External regulatory aspects of the state and others

Large enterprises, especially public interest entities, involve multiple stakeholders and affect the public interest of society, so they need to be regulated, and the stakeholders, especially the government, are indeed as strict as they can be. While SMEs are generally limited liability company system, generally a sole proprietorship, the owner is both the investor and owner, and personally responsible for the operation; or the owner is responsible for the operation, the owner's wife is responsible for the finance, and does not delegate professional managers, and in law the spouse is the principal next of kin, so SMEs are equivalent to no relationship of trusteeship economic responsibility, according to the principal-agent theory, which makes SMEs for internal control demand is limited, which is also in line with the supply and demand theory. State regulation of SMEs is mainly focused on taxation and statistical data reporting.

(2) Aspects of SME's own characteristics

The first thing that SMEs have to solve is the survival problem. It is the most substantial part to ensure the survival first, which is the business problem and the capital problem. Because if the business is not up to standard, the enterprise will definitely not survive, but if the internal control system is not sound, it is not fatal in the short term, and in the long term, given the limitations of the capital budget and the relative certainty of the inherent risk points, the limited demand for internal control mainly lies in the areas of capital, tax, legal, contractual and financial risks. This is in line with Maslow's hierarchy of needs theory.

(3) The personal awareness and ability of SME owners

On the one hand, SME owners think more from their personal and individual perspectives rather than from the perspective of the corporate body of the enterprise. Secondly, SME owners usually come from a business background and are the "first generation to start a business", so they are more market-oriented; moreover, they may not be professional in internal control, so if they implement internal control, they need a team of professional managers.

(4) Job Talent Allocation

Competition in business boils down to competition for talent. However, for SMEs, on the one hand, with SME owners recognizing the importance of internal control, internal control talents are needed due to professional restrictions and time constraints, etc., while there is a lack of resources for a team of professional managers suitable for SMEs. On the other hand, designed effective internal control needs to be executed by people, and the quantity and quality of people who execute internal control affects internal control effectiveness, while SMEs have insufficient ability to attract talents due to the instability of their operations. Human resources limit the effectiveness of internal control, ineffective internal control affects the development and growth of enterprises, and human resources are difficult to retain... , which puts SMEs in a vicious circle.

Research Conclusion

After summarizing and analyzing the interviews with the management of 32 SMEs, this study found that (i) the five elements of internal control, the size of the SME itself, the life cycle it is in and its financial status do have an impact on the effectiveness of internal control. (ii) Internal control of Chinese SMEs needs to be improved and there is more room and potential. (iii) The internal control of SMEs can be improved, and it needs to be improved urgently. This is because strengthening and improving internal control is the way to reasonably ensure the healthy and sustainable development of SMEs, both from the policy and market perspectives. (iv) More importantly, after nearly 20 years of development, the overall trend of internal control in Chinese SMEs is positive, but there are difficulties in actual operation. Specifically, as follows:

1. 73% of the management of SMEs are aware of the importance of internal control and hope that internal control can enhance the ability of enterprises to cope with risks and contribute to the achievement of their goals, but do not know how to start doing internal control. So it is urgent to study how to make SMEs establish and improve internal control.
2. The government needs to regulate, support and guide the internal control of SMEs. On the one hand, it should regulate the strict implementation of "necessary internal controls", and on the other hand, it should encourage and guide them to continuously improve "feasible internal controls". In other words, for the internal control of SMEs, still need the "government's hand", the need for policy economy and market economy hand in hand, the market economy alone is not enough.
3. Internal control should be realistic and pragmatic, not vague; not for good looks, but for good use.

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