

# The Influence of "Reverse Mixed Ownership Reform" on the Internal Control of Private Enterprises

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**Abstract.** Under the background of mixed ownership reform, relying on the trend of "national advance and private retreat", this thesis takes the private enterprises in China's A-share listed companies from 2007 to 2020 as the research sample to explore the impact of "reverse mixed reform". In other words, it is the impact about the internal control entry of state-owned capital into private enterprises on internal control. It is found that the "reverse mixed reform" has significantly improved the internal control level of private enterprises, especially for enterprises that implement the equity incentive system and enterprises that do not concurrently serve as the chairman and general manager. Further research shows that corporate governance structure and financing constraints play a significant intermediary effect, which is especially helpful to alleviate the problem of difficult and expensive financing of private enterprises. This study examines the impact of the "reverse mixed ownership reform" of private enterprises from the perspective of internal control, enriches the relevant research on mixed ownership and internal control, and hopes to provide a theoretical and practical basis for the mixed ownership reform form of state-owned capital entering private enterprises.

**Keywords:** Mixed ownership reform; Internal control; Corporate governance structure; Financing constraints.

## 1. Introduction

From the 14th CPC National Congress, which determined that the goal of economic system reform was to establish a socialist market economic system, to the Third Plenary Session of the 14th CPC Central Committee, the concept of "mixed ownership of property" was put forward. In the process of reform, state-owned enterprises have always occupied a pivotal position. Based on such historical conditions and background, the "mixed ownership reform" was officially put forward at the Third Plenary Session of the 18th CPC Central Committee, with the purpose of further promoting enterprise efficiency and improving corporate governance. Many scholars have also conducted in-depth research on this reform system. A large number of existing documents show that after introducing private capital, state-owned enterprises have greatly improved economic benefits (Wang Shuguang and Xu Yujiang, 2017) and operating efficiency (Megginson et al., 2012) <sup>[2]</sup>.

However, the phenomena and problems of "glass door", "spring door", "revolving door", difficult and expensive financing in private enterprises have not been effectively solved. From the perspective of state-owned enterprises, state-owned enterprises shoulder the great responsibility of national construction and national economic security. In the context of mixed ownership reform, state-owned banks or state-owned enterprises give full play to their own advantages to help or even restructure and merge private enterprises. Objectively, it is not only a protection for private enterprises, private assets and effective productivity, but also a responsibility of state-owned enterprises. "National advancement and private retreat" has also become a historical inevitable choice, "Reverse mixed reform" (that is, the introduction of state-owned capital by private enterprises) has ascended the historical stage.

In recent years, there are also many successful cases of "reverse mixed reform", such as Heli Thai's introduction of Fujian state-owned assets to achieve a win-win situation, Dafu technology's superposition and the sharp rise of state-owned shares. In the implementation opinions on supporting private enterprises to accelerate reform, development, transformation and upgrading issued by the national development and Reform Commission in 2020, private enterprises are also encouraged to

carry out mixed ownership reform. However, in contrast, the existing literature on "reverse mixed reform" is insufficient, so it is very necessary to explore the impact of this economic reform.

Whether it is forward mixed reform or reverse mixed reform, whether state-owned enterprises or private enterprises, for any enterprise, internal control is an important means to improve operation and management and economic benefits. It is the premise and foundation of a series of activities in order to achieve business objectives, protect asset safety and ensure the effectiveness of accounting information disclosure. In recent years, internal control has gradually been regarded as an important feature of the company (Li Yuedong et al., 2017) <sup>[3]</sup>. The Sarbanes Oxley Act (SOx) and the Dodd Frank Wall Street reform and consumer protection act in the United States contain the supervision of the company's financial report in the form of internal control provisions to protect investors from insider manipulation (Stefan et al. 2021) <sup>[4]</sup>. China's Ministry of Finance and other five ministries and commissions jointly issued a series of laws and regulations such as the basic norms of enterprise internal control and the supporting guidelines for enterprise internal control, which further standardize the behavior of enterprises and reduce the occurrence of imperfect internal control system. Thus, the importance of internal control has also risen to an unprecedented height.

From the existing literature, most scholars study internal control as a regulating variable or influencing factor. The research of Sheng Liying and Feng Yanru (2022) <sup>[5]</sup> shows that when enterprises have a good level of internal control, the awareness of heavy pollution enterprises to fulfill social responsibility is enhanced, and the performance of social responsibility is also improved; The research of Yi Yanxin et al. (2022) <sup>[6]</sup> shows that when the internal control is weak and the board of supervisors is more active, the supervision effect of independent supervisors will be better. However, there is little literature on internal control as the impact result, which lacks the exploration of the factors affecting internal control. This study will explore whether the internal control of private enterprises has been improved under the background of "retrograde mixed reform" mentioned above? On the one hand, to make up for the lack of research on the direction of "reverse mixed reform" in the existing literature and exploring the influencing factors of internal control; On the other hand, it verifies the effectiveness of China's "mixed ownership reform" from the perspective of internal control.

## 2. Literature review

### 2.1 The influence of "reverse mixed reform" of private enterprises

According to the existing literature, the impact of the introduction of state-owned capital by private enterprises is mainly reflected in innovation ability, cost expenditure and so on. In terms of innovation ability, many scholars have different views. Zhang Genlin et al. (2020) <sup>[7]</sup> believe that after state-owned capital shares in private enterprises, it does not give full play to the resource advantages, but aggravates the degree of enterprise financing constraints, and then inhibits the technological innovation of private enterprises; Zhu lile et al. (2021) <sup>[8]</sup> believe that the mixed ownership reform can significantly promote the improvement of the overall innovation ability and breakthrough innovation ability of private enterprises, but the impact effect will be different due to the degree of enterprise reform, the development of private economy in the region and the degree of competition in the industry. In terms of costs and expenses, the research of Li Bingcheng et al. (2022) <sup>[9]</sup> shows that the state-owned capital participation significantly reduces the audit expenses of private enterprises. At the same time, the agency cost as a regulating variable, when the agency cost of the enterprise is higher and the local institutional environment is poor, the "reverse mixed reform" of private enterprises plays a more significant role in reducing the audit fees. The mixed ownership reform has significantly increased the debt cost of state-owned enterprises (Su Sanmei and Liu Weifang, 2019) <sup>[10]</sup> and inhibited tax avoidance (Duan min and Fang Hongxing, 2022) <sup>[11]</sup>.

## 2.2 Influencing factors of internal control

There are many factors affecting internal control. This paper divides it into three aspects: the internal governance structure of the company, the situation of senior executives and the situation of shareholders. At the level of governance structure, it is measured by multiple factors. The attendance rate of the year-end general meeting of shareholders, the actual size of the board of directors and the board of supervisors, the establishment of the audit committee, the integrity and moral values of the management, and the attention paid by the management to the competence of employees are significantly positively correlated with the effectiveness of the company's internal control, while the state-controlled companies are significantly better than other companies in the quality of financial reports, and the risk preference of managers is significantly U-shaped with the effectiveness of internal control. For the board of directors, the frequency of the two meetings of the board of supervisors and the control power of the largest shareholder have no significant impact on the effectiveness of internal control (Cheng Xiaoling and Wang huaiming, 2008) <sup>[12]</sup>. At the senior management level, the information technology background of the CEO (Li Ruijing et al., 2022) <sup>[13]</sup> and the chairman as the vertical Senior Manager (Liu Anqin et al., 2022) <sup>[14]</sup> can improve the internal control quality of the enterprise. In terms of shareholders, under the mixed ownership reform, the participation of non-state-owned shareholders in state-owned enterprises can effectively improve the internal control of enterprises (Liu Bin et al. (2019) <sup>[15]</sup>; Liu Yunguo et al. (2016) <sup>[16]</sup>. To sum up, after the introduction of state-owned capital into private enterprises, there are many impact results, especially on the financing constraints, innovation ability and cost of private enterprises, and most of them are positive, which is conducive to promoting social development. Whether external or internal, there are also many factors affecting internal control, mainly reflected in the company's governance structure and serving as senior executives vertically. When private enterprises experience "reverse mixed reform", they can significantly reduce audit costs. Can the internal control governance related to audit be effectively improved? Based on this, this paper takes the enterprise internal control as the starting point, further studies the impact of the "reverse mixed reform" of private enterprises on the internal control on the basis of the existing theories, and gives conclusions and Enlightenment accordingly.

## 3. Theoretical analysis and Hypothesis

### 3.1 "Reverse mixed reform" and internal control

The "reverse mixed reform" allows state-owned capital to enter private enterprises to integrate different property rights. However, the original state-owned enterprises and private enterprises have different management methods, different business objectives, and different internal control quality and formulation standards. The property rights of state-owned enterprises belong to the state, and the government exercises relevant rights and assumes obligations on behalf of the state. The actual situation is that the State Council has the asset supervision and Administration Commission which can become the investor of state-owned enterprises and assume the supervision responsibilities (Huang Yulian, 2019) <sup>[17]</sup>. Therefore, state-owned enterprises pay more attention to ensuring the safety and value-added of assets and ensuring the compliance and discipline of Party and government cadres. However, private enterprises aim to maximize the interests of shareholders and pay attention to the actual economic interests of the company. Therefore, how to strengthen the efficiency of operation is the core of internal control.

On the one hand, although state-owned enterprises have problems such as rigid management, their political attributes and value orientation of adhering to social benefits make them more conscious in complying with government rules and regulations, and have established a relatively standardized organization management and internal control system (Liuq Qiliang and Zhao Chao, 2014) <sup>[18]</sup>. When private enterprises incorporate state-owned capital, the government attribute of state-owned enterprises will improve the internal control quality of private enterprises through a deterrent effect.

Moreover, compared with non-state-owned enterprises, the ratio of self-evaluation on the overall effectiveness of internal control of state-owned enterprises is higher than that of non-state-owned enterprises. It can also significantly improve the quality of internal control of state-owned enterprises and the participation of the party and government system (Cui Jiujiu, 2021) <sup>[19]</sup>, which are also unique excellent characteristics of state-owned enterprises.

On the other hand, state-owned shareholders are likely to guide private shareholders to obtain financial subsidies by non-market means in order to achieve political goals (Yu Minggui et al., 2010) <sup>[20]</sup>, making internal control lose its due role. At the same time, this kind of political connection will increase information asymmetry, so that the risk of "large shareholders are above internal control" of private enterprises can be restrained (Pan Ailing et al., 2019) <sup>[21]</sup>. Therefore, I believe that compared with private enterprises, the internal control and supervision of state-owned enterprises are stricter, and the background of their government attributes will reduce the final decision-making of the top leader in private enterprises. At the same time, with the introduction of the internal control system under the government supervision, stricter supervision systems and regulations can reduce the occurrence of internal fraud, weaken the motivation of enterprises to voluntarily disclose internal control reports (Zhang Zhiping et al. and Fang Hongxing, 2013) <sup>[22]</sup>. Even if an enterprise blindly implements the system on the surface to deal with supervision and inspection, it will not only consume a lot of financial and material resources, but also ignore the design of internal control. In addition, the actual situation is that the state-owned equity lacks the characteristics of effective shareholders, resulting in its weak willingness to supervise private enterprises, which makes it difficult to form a balance of rights for the major shareholders or management of private enterprises, and increases the motivation of enterprises to carry out earnings management (Tu Guoqian and Liu Feng, 2010) <sup>[23]</sup>, which in turn is not conducive to the implementation of private enterprise management system and the performance of internal supervision.

Based on the above analysis, two assumptions are proposed:

H1a: "Reverse mixed reform" can effectively promote the effectiveness of internal control of private enterprises.

H1b: "Reverse mixed reform" can significantly reduce the effectiveness of internal control of private enterprises.

### **3.2 "Reverse mixed reform", concurrent employment and internal control**

In a joint-stock enterprise, there are mainly four governing bodies: the board of shareholders, the board of directors, the board of supervisors and the management. The shareholders' meeting or general meeting is the highest authority and decision-making body of the company; The board of directors is in charge of the company's affairs internally and represents the company's business decisions and business execution externally; The board of supervisors shall supervise and inspect the business activities of the company; The management carries out the decisions of the company. The four internal organizations have different functions and roles, complement and restrict each other, and are vertically layered and authorized at different levels, which together constitute the internal governance structure of the company.

In most enterprises, the organizations of these four parts are held by different principals. In particular, the ownership and management rights of the company are separated. The actual controller of the company does not participate in the management of the enterprise, but hires talents to form an excellent management team to carry out the actual business. The greatest advantage of this is that it can achieve the optimal combination of enterprise resources and management personnel and maximize the benefits, so that to bring maximum profits to the owners. Therefore, under this measure, the chairman and the general manager of the company are usually held by different personnel, which can effectively play the supervision and restriction functions of various authorities, reduce the occurrence of fraud, and also restrict the rights of the senior managers, because their operation of the company is authorized by the actual owners, and also be supervised by the board of directors, the board of supervisors and other institutions at all times, which let them not easily expand their rights.

In general, it will improve the internal control level of the company. However, there is no lack of the situation that the chairman of the board of directors and the general manager concurrently serve in the existing companies, which also gives birth to another view. When the chairman of the board of directors concurrently serves as the general manager, the power is highly concentrated, and the enterprise characteristics are better understood from all aspects, so that more effective business decision-making and management systems can be formulated, and the internal control system of the enterprise can be better practiced.

Therefore, based on the above analysis, hypothesis 2 is proposed:

H2a: It is more effective to improve the internal control of the enterprise if the chairman and the general manager do not serve concurrently.

H2b: It is more effective to improve the internal control of the enterprise if the chairman and the general manager do serve concurrently.

#### 4. Conclusions and enlightenment

This paper takes the private enterprises listed on China's A-share market from 2007 to 2020 as the research object, and empirically tests the impact of the "reverse mixed reform" of private enterprises on the internal control of enterprises. The results show that: ① When state-owned capital enters private enterprises, it can effectively improve the level of internal control. ② The fact that the chairman and general manager of the company do not hold concurrent posts and the company implements the equity incentive system can further promote the effectiveness of internal control. ③ "Reverse mixed reform" can improve the level of internal control of enterprises by improving corporate governance structure and easing financing constraints.

In this regard, based on the research conclusions of this paper, the following enlightenment is obtained:

(1) The introduction of state-owned capital has a positive impact on the easing of financing constraints of private enterprises and the improvement of internal control level, thus promoting the further development of social economy. The difficulty and high cost of financing for private enterprises has always been a major problem, and it is also an important challenge for private enterprises. Therefore, from a long-term perspective, if the relevant private enterprises still have a strong capacity for sustainable development and can continue to create value for the society, they should alleviate the financing constraints through the cooperation between the government and social capital like methods as introducing state-owned capital into private enterprises, so as to promote the further development of enterprises and social economy.

(2) Private enterprises should strengthen the management mechanism of internal control. On the whole, the internal control of private enterprises remains at a medium to high level, but there are great differences among enterprises. Further strengthening the level of internal control is still the top priority of enterprise development. Firstly, we should strengthen the innovation of internal control to make it conform to the changes of enterprise development. Secondly, we should strengthen the internal governance structure, which includes clarifying the specific responsibilities of each position, reducing the internal control defects caused by personnel holding concurrent posts, appropriately expanding the size of the board of directors and the board of supervisors, giving full play to their due decision-making and supervision roles, and finally improving post event control, put forward practical suggestions and measures for the existing problems and strengthen the technical and professional ethics training of relevant personnel.

(3) Before the state-owned capital chooses to enter the private enterprises, the private enterprises should be evaluated reasonably and comprehensively. Try to choose enterprises with good governance structure and perfect modern system, which are similar to those with equity incentive policies. These enterprises can effectively alleviate the agency problems caused by the separation of two rights and many problems that hinder the operation and development of enterprises caused by internal control. In this way, when the state-owned capital enters, it can give better play to its

characteristics, improve its capital flow efficiency, and better help the development of private enterprises.

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