

# Research on the Relationship between Venture Capital and Business Performance

## -- Based on the Moderating Effect of Internal Controls

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### Abstract

Whether venture capital can have a significant impact on business performance is a matter of great concern in China. However, it is not clear whether the integration of internal control and venture capital investment in small, medium, and medium-sized GEM-listed companies will bring greater performance effects to listed companies. This paper chooses SME and GEM enterprises as the research object and empirically explores the effects of venture capital, internal control on the company's business performance, and the moderating effect of internal control on the relationship between venture capital and business performance. The results show that, in the corporate governance structure, risk investment has a positive impact on the company's business performance; the positive impact of internal control on the company's business performance; internal control has a significant moderating effect, and high-quality internal control has a significant positive impact on the company's performance. That is, through the internal management of the company, the utility of the company's risk investment can be maximized, so that the company's performance can be sustained growth. This paper proposes targeted management recommendations based on the results of the study.

### Keywords

Venture Capital; Internal Control Quality; Corporate Performance; Moderating Effect.

## 1. Introduction

In China, small and medium-sized enterprises (SMEs) are the main body of technological innovation and play a pivotal role in promoting the transformation of China's development model, creating tax revenue and increasing employment. Financing of SMEs has long been the core issue of concern for enterprises, and venture capital is a major way to solve the financing dilemma. For SMEs and Growth Enterprise Markets (GEMs), the most suitable way of financing is venture capital, which has an important impact on the production and management of enterprises. The improvement of enterprise business performance is closely related to enterprise management environment and enterprise governance ability. Strengthening enterprise internal control management plays an important role in improving enterprise business environment and governance ability. Therefore, whether venture capital can have a significant impact on the business performance of enterprises, and whether good internal control of enterprises will have an impact on the relationship between venture capital and business performance has become a very concerning issue. No scholars have yet studied the relationship between internal control, venture capital, and business performance for SMEs and GEMs, and this study can fill the gap in the literature and provide useful references for the governance of SMEs and GEMs.

For this reason, this paper takes small and medium-sized board and venture board enterprises as the research object, for the impact of venture capital, internal control on the company's business performance, and the moderating effect of internal control on the relationship between venture capital and business performance are empirically explored. From the A-share market, 693 companies that have been funded by venture capital from 2017 to 2021 were selected as samples to obtain the panel data for this study. The data were obtained from the Dib database and Cathay Pacific database and Stata16 was used for data processing. The results of the study verified that venture capital has a positive impact on the company's business performance, and internal control has a significant moderating effect role, this paper puts forward targeted management recommendations based on the results of the study.

## 2. Literature Review

### 2.1. Venture Capital and Internal Control

Currently, most researchers at home and abroad believe that venture capital has a positive impact on the internal control of enterprises. Hochberg et al. study shows that after venture capital enters the company, it can improve the governance structure of the company, and then enhance the governance of the company, which has a positive effect on the internal control of the company (Hochberg, 2007). Baker & Gompers' study shows that Venture capital can improve the internal environment of investee companies by positively promoting the role of the board of directors and managers, which in turn reduces the company's information risk and improves the quality of the company's internal control (Baker & Gompers, 2003). The study by Bi shows that the inclusion of venture capital can improve the quality of internal control of listed companies; the study also shows that the inclusion of venture capital has a positive effect on both risk assessment and regulation of the company (Bi, 2018). Yang pointed out that the participation of venture capital has a positive effect on the internal control of the company, which can help the company to build a better internal control system, especially the long-term venture capital has a more obvious impact on the internal control of the company (Yang, 2019). Li et al. pointed out that venture capital investment can significantly reduce the company's internal control deficiencies, and its impact on the company's internal control deficiencies will be greater with the increase of venture capital holdings (Li et al., 2019).

### 2.2. Venture Capital and Enterprise Performance

Many foreign scholars have conducted a lot of research and discussion on whether venture capital participation can play an enhancing role in corporate performance. Although opinions are not unanimous, most researchers believe that the relationship between venture capital and firm performance is positively correlated. Sun et al. showed that with the help of venture capital, firms' innovation performance will be better (Sun et al., 2020). Shang et al., in their study on whether venture capital involvement has a positive impact on firms, found that venture capital can positively contribute to firms' innovation and regulation (Shang et al., 2020). Yuan through a study of NSS board enterprises, found that the intervention of venture capital can bring rich social network resources to the invested enterprises, which can lead to greater development of the enterprises (Yuan, 2020).

### 2.3. Internal Control and Firm Performance

In the study of the relationship between internal control and corporate performance, there is a convergence of views among scholars who agree that high-quality internal control positively affects corporate performance. Bolton et al. found that in firms with higher quality of internal control, there is less decline in stock prices, higher quality of accounting information, and less volatility in corporate performance (Bolton et al., 2016). Weli et al. showed that firms with higher levels of internal control disclosure performed better in terms of market performance,

and quality of accounting information, and were more favorable to the steady growth of the firm (Weli et al., 2018). Xie & Jiang argued that the internal control of manufacturing companies in China is still at a relatively low end in general, and, due to the differences between different industries and different industries, it makes the performance of companies vary greatly (Xie & Jiang, 2019).

The above literature review shows that although there is no consensus on the role of venture capital on firm performance, there is a consensus that the role of internal control quality on firm performance is positive. To further clarify the relationship between the three and to fill this gap in the literature, this paper focuses on the link between venture capital and internal control quality and firm performance. We use internal control as a moderating variable in our study of the impact of venture capital on firm performance to explore the link between these three factors.

### **3. Research Design**

#### **3.1. Research Hypotheses**

##### **3.1.1. The Impact of Venture Capital on Business Performance**

The intervention of venture capital can alleviate the financial difficulties of SMEs and provide them with financial support for research, development, and other activities, thus solving their financing problems and providing good help to business operations. Research by many scholars has pointed out that there is a close relationship between venture capital and the performance of portfolio companies in start-ups. Venture capital can not only provide the necessary funds for the investee company but also participate in the company's operating activities, thus improving the governance of the investee company, playing a supervisory effect, and improving the company's performance. At the same time, venture capital has certain screening skills, and the intervention of venture capital makes the operational performance of investee companies significantly higher than that of companies without venture capital intervention. The capital flow and turnover of companies with venture capital intervention are much larger than those without venture capital. Venture capital can have a significant boosting effect on entrepreneurial firms, thus driving up the future value of the firm. Thus, the hypothesis is formulated as follows.

H1: There is a significant positive correlation between venture capital investment and firm performance for SMEs and GEMs.

##### **3.1.2. The Impact of Internal Control on Business Performance**

Internal control is designed to effectively regulate the various behaviors of the company (Zheng & Liu, 2021). In general, companies with good and complete internal control environments and systems. The performance appraisal and performance incentive system for managers and employees will be more robust, which is a guarantee of improved company performance. Tettehet et al. argued that companies with an effective flow of information, communication, and technology have higher financial performance, and the financial performance of companies that have invested in effective internal control systems has been further improved (Tettehet et al., 2020). Xu et al., based on empirical analysis and based on the delegation theory and the information asymmetry theory, suggested that internal control improves a company's financial performance (Xu et al., 2021). The more complete an enterprise's internal control system is, the more rules and regulations will be followed in the daily affairs of the enterprise, and therefore the probability of unconscious errors will be reduced, which will have a positive impact on the improvement of the company's business performance. Therefore, the author believes that the establishment of a sound internal control system can improve the company's risk prevention ability, improve the scientific nature of the company's operation and management, and thus

reduce the cost of the enterprise and improve its business performance. To this end, the following hypotheses are proposed.

H2: The better the quality of internal control, the more it can promote the improvement of the company's operating performance, and the two are positively correlated.

### 3.1.3. The Moderating Role of Internal Control on the Relationship between Venture Capital and Enterprise Business Performance

According to Deng, in a good corporate environment, the internal governance of an enterprise can more effectively promote the healthy development of the enterprise (Deng, 2018). Internal control is an effective management tool for the internal management of enterprises, which can maximize the improvement of the internal processes of enterprises, not only to create a good internal and external atmosphere but also to play a positive role in promoting the company's business performance. When the internal control of the enterprise is not perfect enough, the impact of venture capital on business performance will be weakened due to more chaotic internal management and increased management costs. On the contrary, when the internal control of the enterprise is more perfect, the risk investment in the business performance of the enterprise will be strengthened. Therefore, the hypotheses are proposed as follows:

H3: High-quality internal control strengthens the effect of venture capital on business performance.

## 3.2. Sample Selection and Data Sources

By the characteristics of venture capital, this paper selects 693 companies that have been funded by venture capital from 2017 to 2021 as the research object. The data of internal control indicators used are from the Dib database, other data are from the CSMAR database, and Stata16.0 is used for data processing.

To ensure the completeness and validity of the data, the raw data were processed as follows.

- (1) Considering that companies in trouble in operation management and finance may generate moral hazard or whitewash their performance, ST, SST, and PT companies are excluded;
- (2) Considering that venture capital organizations may be acting in concert with GEM-listed companies, which may cause damage to the independence of venture capital, enterprises in which venture capital is the major controlling shareholder are excluded;
- (3) excluding enterprises with incomplete data on internal control quality;
- (4) excluding samples with missing data.

## 3.3. Definition of Variables

**Table 1.** Description of variables

Variable	Name	Symbol	Variable Definition
Explained variable	Operating performance	ROE	Net profit/total assets
Explanatory variable	Venture capital shareholding	VCSH	Venture capital total shareholding/total shares
Moderating variable	Internal control quality	IC	Dib internal control index
Control Variables	Firm Size	SIZE	Logarithmic total assets of the firm
	Total Asset Turnover	TTM	Operating Income/Total Assets
	Gearing ratio	DEBT	Total liabilities/total assets
	Board of Directors Independence	DEP	Number of Independent Directors/Total Number of Board of Directors

In this paper, we use operating performance (ROE) as the explanatory variable, venture capital shareholding (VCSH) as the explanatory variable, internal control quality (IC) as the moderating variable, and refer to the research of scholars such as Lim and Chou (Lim, 2009; Chou, 2019), and choose the following indexes as the control variables: enterprise size (SIZE), total capital turnover (TTM), board size (BOA), board independence (DEP), and gearing ratio (DEBT) as control variables. The specific definitions of the variables are shown in Table 1:

### 3.4. Empirical Modeling

We will analyze the interaction between venture capital and corporate performance from both theoretical and empirical aspects, considering that the data used are dynamic panels using a generalized method of moments estimation for modeling, and based on this, we will study the moderating role of internal control quality. To test Hypothesis 1, the relationship between venture capital and firm performance, the following model 1 is constructed.

$$ROE_{i,t} = \alpha_0 + \alpha_1 ROE_{i,t-1} + \alpha_2 VCSH_{i,t} + \alpha_3 M_{i,t} + \varepsilon_{i,t}$$

$\alpha_0$  is a constant term,  $M$  is a control variable,  $\varepsilon_{i,t}$  residual term,  $i$  and  $t$  are subscripts representing the individual and time of the study, respectively. When the coefficient of  $VCSH$ ,  $\alpha_2$  is significantly positive, it indicates that venture capital has a positive impact on firm performance, supporting Hypothesis 1.

To test hypothesis 2, the relationship between internal control and corporate performance, the following model 2 is constructed as follows.

$$ROE_{i,t} = \beta_0 + \beta_1 ROE_{i,t-1} + \beta_2 VCSH_{i,t} + \beta_3 M_{i,t} + \varepsilon_{i,t}$$

$\beta_0$  constant term,  $M$  is the control variable,  $\varepsilon_{i,t}$  is the residual term, and  $i$  and  $t$  are subscripts representing the individual and time of the study, respectively. When the coefficient  $\beta_2$  of  $VCSH_{i,t}$  is significantly positive, it indicates that internal control positively affects firm performance, supporting Hypothesis 2.

To test hypothesis 3, internal control quality is introduced as a moderating variable to study the role played by internal control quality between VCS and firm performance, and model 3 is constructed as follows.

$$ROE_{i,t} = \gamma_0 + \gamma_1 ROE_{i,t-1} + \gamma_2 VCSH_{i,t} + \gamma_3 IC_{i,t} + \gamma_4 VCSH * IC_{i,t} + \gamma_5 M_{i,t} + \varepsilon_{i,t}$$

$\gamma_0$  is the constant term,  $M$  is the control variable,  $\varepsilon_{i,t}$  is the residual term, and  $i$  and  $t$  are subscripts representing the individual and time of the study, respectively. When the coefficient  $\gamma_4$  of  $VCSH * IC$  is significantly positive, it indicates that the better the internal control quality indicators, the greater the positive impact of venture capital on corporate performance, supporting hypothesis 3.

## 4. Results

### 4.1. Descriptive Analysis

Table 2 presents the descriptive statistics of the samples of each variable. The average level of return on net assets as a measure of company performance is 8.80%, and its minimum value is negative, which indicates that there are large differences between the performance of small and medium-sized GEM companies. The mean value of VC ownership is 4.85%, but there is a wide variation in the level of VC ownership at different levels. The mean value of the internal control

quality index is above 500, but the standard deviation is relatively large, which indicates that although most of the sample companies have better internal control quality, there is still a big difference between individual companies. In terms of the proportion of independent directors, we can find that although there are still some companies with a proportion lower than the required one-third of that proportion, the average is 0.384, which meets the requirement. The standard deviation is still large after taking the logarithm of the company size, indicating that it shows that the size of the sample companies varies a lot, which is useful for a diversified investigation.

**Table 2.** Results of descriptive analysis

Variable	Mean	SD	Min	Max
ROE	0.088	0.105	-1.849	0.883
IC	641.2	168.8	94.73	920
VCSH	0.0485	0.0956	0	0.0916
TTM	0.678	0.544	-0.048	12.373
SIZE	22.450	1.313	19.138	28.636
DEBT	0.426	0.197	0.007	1.406
DEP	0.384	0.0531	0.333	0.600

#### 4.2. Correlation Analysis

To test the hypotheses, the correlation of variables is first analyzed as follows. The correlation test results in Table 3 show that corporate performance is significantly and positively correlated with venture capital shareholding at the 10% level. The research results show that the company's business performance will be significantly improved after the participation of venture capital, which preliminarily verifies hypothesis 1 of this paper; the internal control index is significantly and positively correlated with the enterprise performance at the 10% level, and the results can indicate that when the company's internal control level is high, the company's business performance is better; the interaction term of the quality of internal control and the proportion of venture capital shareholding is also significantly and positively correlated with enterprise performance at the 10% level, and the correlation coefficient of the interaction term is higher than the proportion of venture capital shareholding. correlation, and the correlation coefficient of the interaction term is higher than the proportion of venture capital holding, which implies that there exists a certain moderating effect of the quality of internal control on the venture capital and corporate performance, and provides a preliminary validation of Hypothesis 2 and Hypothesis 3 of this paper. Further observation shows that. Board independence, gearing ratio, and firm size all hurt firm performance; increasing the firm's total asset turnover ratio contributes to firm performance. There is also no excessive correlation between the control variables, and their correlation coefficients are less than 0.5, indicating that the model is analyzed without serious multicollinearity problems.

**Table 3.** Results of correlation analysis

Variable	ROE	IC	VCSH	TTN	SIZE	DEBT	DEP
ROE	1.00						
IC	0.259*	1.00					
VCSH	0.062*	0.045*	1.00				
TTN	0.045*	0.30***	0.18***	1.00			
SIZE	0.25***	0.28***	0.23***	0.42***	1.00		
DEBT	-0.24***	0.17***	0.05***	0.08***	0.06***	1.00	
DEP	-0.05***	0.12***	0.01	0.16***	0.31***	0.01	1.00

Note: \*, \*\*, and \*\*\* indicate statistical significance of 10%, 5%, and 1%, respectively.

### 4.3. Regression Analysis

After we analyze the correlation of the relevant variables of the sample data, we can find that there is no problem of multicollinearity in these models. At the same time, because the role of venture capital on invested enterprises is a long, potential, continuous, and uncertain process, the explanatory variables of enterprise performance are used in this model to start the analysis with the data of the latter period. Table 4 shows the regression results of Model 1, from which it can be seen that the coefficient of the proportion of venture capital shareholding is significantly positive at the 5% level under the measure of return on net assets as a measure of corporate performance, which indicates that venture capital is positively correlated with corporate performance, and participation in venture capital contributes to corporate performance, and Hypothesis 1 is proved. This paper also analyzes and concludes that the degree of independence of directors is not detrimental to the improvement of corporate performance, but it has no significant effect on it; the gearing ratio is significantly negative at the 5% level, which indicates that the lower the gearing ratio is and the less the debt is, the better the performance of the enterprise is.

**Table 4.** Results of regression analysis(1)

Variable	Coefficient
VCSH	0.0687** (0.0269)
DEBT	-0.268** (0.135)
TTM	0.176* (0.0135)
DEP	-0.280 (0.200)
SIZE	-0.0104 (0.00908)
cons	-0.523**

Note: \*, \*\*, and \*\*\* indicate statistical significance of 10%, 5%, and 1%, respectively.

**Table 5.** Results of regression analysis (2)

Variable	Coefficient
IC	0.0999*** (0.0548)
DEBT	-0.0157** (0.0723)
TTM	0.0734** (0.0339)
DEP	0.0400 (0.0325)
SIZE	0.0245*
cons	-0.601**

Note: \*, \*\*, and \*\*\* indicate statistical significance of 10%, 5%, and 1%, respectively.

From Table 5, it can be concluded that the regression coefficient between the quality of internal control and firm performance is 0.0999 and it passes the test of significance at a 1% level. This

shows that the higher the quality of internal control, the better the firm's performance, thus proving that hypothesis 2 is correct. The results of the study also show that the size of the company is positively related to the performance of the company, while the gearing ratio of the company is inversely related to the performance of the company, and there is no significant correlation between the ratio of independent directors of the company and the performance of the company.

Table 6 shows the regression results of model 3, from which it can be seen that with return on net assets as a measure of corporate performance and adding internal control quality as a moderating variable, the coefficients of the interaction terms of the proportion of venture capital holdings, the internal control index, and the proportion of venture capital holdings and the internal control index are all significantly positive at the levels of 5%, 1%, and 1%, which suggests that the moderating effect of the quality of internal control can amplify the positive effect of venture capital investment on the performance of the company in a company with a good quality of internal control and thus promote a positive increase in the performance of the company, and Hypothesis 3 has been verified.

**Table 6.** Results of regression analysis (3)

Variable	Coefficient
VCSH	0.0827**
IC	0.0197***
VCSH*IC	0.0425***
DEBT	-0.173*
DEP	-0.254
SIZE	0.0443
cons	-0.338***

Note: \*, \*\*, and \*\*\* indicate statistical significance of 10%, 5%, and 1%, respectively.

#### 4.4. Robustness Test

At the end of the paper, the return on equity (ROE) is used as a substitute variable to conduct robust regression. The robust regression results are shown in Table 7.

**Table 7.** Results of robust regression

Variable	Coefficient	Std.Error	t-Statistic	Prob.
ROE	0.018954***	0.002747	6.900169	0.0000
IC	0.091029***	0.030867	34.53807	0.0000
VCSH	0.421143***	0.011314	37.22455	0.0000
DEBT	-0.347006***	0.032736	43.76832	0.0000
DEP	0.001464***	0.002372	27.86559	0.0000
TTM	0.019094***	0.020297	12.21856	0.0000
SIZE	-0.121902***	0.002110	-57.77938	0.0000
R-squared	0.953225			
Adjusted R-squared	0.929735			
F-statistic	40.57976			
Prob(F-statistic)	0.000000			

As can be seen from the robust regression results shown in the table, the regression coefficient between internal control quality and ROE is 0.091, which passes the T-test at the level of 1%, indicating that internal control quality and ROE are positively correlated, which is consistent



with the previous results. Similarly, it can be seen that the correlation coefficient between venture capital, quality of internal control, and return on equity has no significant changes and the degree of significance has not changed significantly compared with before, and the conclusion is roughly the same as above. There is no endogeneity problem, indicating that the regression results in this paper are robust. This paper shows that the model establishment and the conclusion of the study on the moderating effect of internal control on venture capital and firm performance are convincing and reliable.

## 5. Conclusion

To clarify the effect of venture capital on the business performance of enterprises, as well as the issue of the impact of the quality of internal control of enterprises on the relationship between the two. In this paper, 693 companies that have been supported by venture capital among the listed companies in SMEs and GEMs during the period from 2017 to 2021 are selected as the research object. Through the above research, it is found that the intervention of venture capital has a positive impact on the performance of investee companies, that is to say, after the venture capital enters into the investee companies, it will use their professional management knowledge and financial knowledge to provide value-added services for the investee companies, and thus promote the performance; the quality of internal control plays the role of moderating variable, positively moderating the relationship between the venture capital and the performance of the enterprise. The quality of internal control acts as a moderating variable, positively moderating the relationship between venture capital and corporate performance. That is internal control, as the cornerstone of corporate development, can amplify the effect of venture capital on corporate performance and play a positive role in maintaining the steady development of corporate performance. This study bridges the gap in the relevant literature in this area, and the results of the study provide useful references to the corporate governance of SMEs and GEMs. Through the above research, this paper makes the following recommendations:

(1) recommendations at the venture capital level. The success of venture capital investment is closely related to corporate performance. Therefore, before investing, venture capital institutions should fully understand the invested enterprises and make a comprehensive assessment, and they can make a clear explanation of the specific investment mode, for example, they can take the way of phased investment and joint investment to reduce the risk; in the process of venture capital's involvement in the operation of the enterprise, they can ensure that the invested company can fulfill the commitment it made before investing through its participation in the board of directors, appointment of managers and other measures. In the process of venture capital's involvement in the enterprise's operation, it can ensure that the invested company can fulfill the commitments it made before investment through its participation in the board of directors and appointment of managers.

(2) Suggestions at the enterprise level. To prevent conflicts caused by the lack of unity of purpose between the company and the venture capital organization, the company should also evaluate the venture capital funds by taking into account the reputation, scale, resources, and past investment projects of the venture capital organization, and introduce the most suitable venture capital funds to the company when necessary. Prevent the phenomenon that VCs' short-term actions lead to adverse effects on long-term company performance. Enterprises should recognize that internal control is the foundation of the company's development, and they should start from the strategic objectives of the company to improve their internal control appropriately, focusing on internal control quality and internal control effectiveness.

Although this study explores the three relationships of internal control quality, venture capital, and business performance and obtains the corresponding findings, there are some limitations:

first, based on the factors of data availability, we apply the concept of venture capital in a broad sense to explore their impact on business performance, but we do not differentiate venture capital from private equity investment. Second, we chose net asset margin as an indicator of firm performance, but this indicator is a financial one, and other non-financial indicators were not considered in this study. Subsequent research can distinguish venture capital from private equity investment and provide a comprehensive measure of corporate performance to make the study more objective and complete and further validate the conclusions of this study.

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