The Research on Internal Controls in Chinese SMEs

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Abstract. Nowadays, lacking awareness of internal control has been the first difficulties that managers face in addition with problems on internal environment and the control systems, the control cost, supervisory mechanism. The article aims to discuss the problems and give the recommendation for SMEs.

Introduction

In recent years, internal control gets increasing attention and plays a very important role on the high efficient management mechanism of modern enterprise. Since the reform and opening-up, economic structure of China has changed a lot. One of the changes is the explosive growth of SMEs. Obviously, the growth makes a huge impact on the unemployment rate reduction and people’s livelihood improvement and even the GDP boost of China. However, be limited in size, fund and managerial expertise, plenty of the SMEs face difficulties on the systematization, standardization and procedure of internal controls. For the difficulties, first of all, SMEs may lack the recognition of internal controls. Secondly, some of managers might make a wrong plan of the internal control standardization. Moreover, the cost of internal controls is high. Furthermore, there might be no supervisory mechanisms on SMEs’ internal control. There is no doubt that it will be of important significance to ensure the implementation of national policy, improve the quality of the accounting information and achieve the development goals of enterprises with a well-found internal control system. However, the way and system on internal controls of SMEs in China is still immature currently. How to refine the internal controls for SMEs has been a great and hard task in China economy.

Research Methods

Normative research is the major method of this dissertation. The dissertation is divided into three parts to raise, analyze, solve questions. For the first part, the concepts of internal control are provided which referenced by books, reports and relevant laws and regulations. In the second part, it explains questions on internal controls of SMEs and attempts to analyze the causes with the way of both actual and literature research. Over the last part, it makes a set of systems and methods for SMEs internal controls based on SME’s own characters, internal controls’ concept combined with the cause of the questions and actual facts. It aims to help improving and enhancing internal controls for Chinese SMEs.

Small and Medium-Sized Enterprises

Over decades in the past, great changes have taken place in Chinese economic structure. The SMEs plays much more important role in national economy. Compared with normal enterprises, SMEs have its own characteristics [1]. First of all, SMEs survive with smaller scales, flexible
operation and high efficiency. They hire less employees and make lower profit without setting up redundant regulations. Their production all depends on people’s needs in the market which makes their work more flexible [2]. They neglect company culture, strategic plans, internal control and risk management, because short-term profit is what they concern more about. Secondly, most SMEs are established privately, that the ownership and managerial authority are undistinguished. In China, most of SMEs are partnership enterprises, joint-equity enterprises, sole proprietorship or limited liability company [3]. Compared with large-sized company, the owners of SMEs are usually managers and operators. The concentration of rights and liabilities leads to the ignoring or missing of internal control in SMEs. Furthermore, weakness of operation system always exists in SMEs, and the way of internal control is immature. The weakness causes accounting information inaccurate or false, so that some SMEs cannot get high credit rates. Moreover, SMEs get limited resources, high risk and short lifetime. Because of the small business scale and small funds, cutting the cost is the way that most managers of SMEs prefer to choose when they face difficulties. It may result in business system impaired, the brain drain, the support trust of finance institution lost. That is the real vicious spiral [4].

Internal Controls

As a definition, internal Control is ‘a process for assuring achievement of an organization's objectives in operational effectiveness and efficiency, reliable financial reporting, and compliance with laws, regulations and policies. A broad concept, internal control involves everything that controls risks to an organization’ [5]. In 2008, Internal Control-Integrated Framework was published by Chinese government department and pointed out five principles on implementation of internal control. First of all, it is comprehensiveness. Internal control must be related to decision making, implementation and supervision and cover all parts of business in the enterprise. The second is the materiality principle [6]. Based on total control, the internal control must focus on important business and high risk areas. Thirdly, it is checks and balances that it should be restricted and supervised among departments, progresses, rights and liabilities efficiently. The fourth is adaptability that internal control should adapt to business scale, business scope, competitive environment and risk level. The last one is cost and profit, that internal control should balance the cost and anticipated benefit to control efficiently [7]. It is significant for modern enterprise management process to follow the principles of internal control to keep management process smoothly, efficiently and compliantly.

The Problems and Causes of Internal Controls in SMEs

It has come into being a mature internal control system in the west countries because they apply much more earlier on it after several development stages compared with China. In the middle 1980s, Chinese scholars start internal controls studies, but not play a good performance. Since we entered the new century, an increasing number of people pay attention on the internal control, and the regulations of it comes out in force. The study of the internal controls steps on an all-time high stage. However, it still cannot fill the needs of internal controls for modern enterprises in China. Most studies aim on the framework, elements and theories of the internal controls which are exaggerated and not of practice [8]. The studies are focused on the improvement and optimizing of the control systems, not attach importance to internal check. It causes that the internal control system becomes more complicated and cannot prevent company from fraud and corruption. In addition, it is for large-scale enterprise to more Chinese regulations and laws [9]. For example, that Internal Control Standards are not regulated on the SMEs is the real internal control system deficiencies. In China, internal control standards and systems in most enterprises are immature. Some of them do not have a culture in the company. The company culture is about management philosophy, ethics and lifestyle which is developed in the long run. A well company culture is able to help internal control system ran perfectly [10]. For SMEs, the cost of internal controls is high that they cannot make lots of profit.
The short-term profit and efficiency is what they concern more about. The most important is there is no supervision mechanism in Chinese SMEs which causes the information is hard to distinguish false or not. There is no auditing department or auditor in most SMEs.

Summary

In conclusion, there are problems of internal control on account of both SMEs’ own characteristics and business environment. Some recommendations are given by the author for SME internal control. Firstly, government departments should issue more regulations and laws to orient the SMEs and set up a well-found system of internal control for enterprises in China. Secondly, managers of SMEs should be improved on the awareness of internal control, the way should get more simplifications. Thirdly, it should be attached importance to enterprise cultural construction with higher quality of employees. The Fourth is that the cost of internal control should be reduced which is depended on management techniques. The last and the most important is the supervisory mechanism and information system should be established in most of SMEs to guarantee a better and true business environment. As it is believed, internal control is going on the right way by government intervention and the improvement of manager’s awareness in SMEs.

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References