



Internal Audit for SMEs in China

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Internal Audit for SMEs in China

Overview

Internal audit is an evaluation of a business's internal controls and an analysis of the degree to which an enterprise reaches its core objectives. Historically an internal audit was often viewed as something irrelevant or something that did not bring value to an SMEs (small and medium enterprises). The good news is that SMEs owners are becoming more aware of the significance of sound internal controls. They are taking more consideration about the control environment, which is the critical component of the internal audit frameworks. However, the internal audit is still regarded as only relevant to large entities like publicly listed companies or governments. This is predominantly due to the business operation misconception that SMEs are relatively less complicated, and the business owner is always involved in the daily operations directly.

The control environment of SMEs may differ from large organizations. But they should still be reviewed regularly in order to ensure effective risks management. The risks may vary with the nature of the business, as well as external factors including the overall economic environment, government policies, etc.

Benefits

In the context of control environment for SMEs, the risk management effectiveness is deeply determined by the business management people. It is very important that an SME ensures awareness of the control environment, and that management understands and have the right, attitude and actions towards the internal control system for SMEs overall objectives. The control environment sets the tone and the organization culture.

An effective control environment will ensure

- Operations effectiveness and efficiency;
- Financial reporting reliability;
- Laws and regulations compliance;
- Assets safeguarding.

An Overview of Internal Controls for SMEs

Referring to the audited entity, internal controls will be used in order to

- Ensure the effective conduct of business activities;
- Protect the assets security and integrity;
- Prevent, detect and correct errors and fraud;
- Ensure the accounting to be true, lawful, and complete;
- Formulate and implement the relevant policies and procedures.

The content includes management control, accounting controls and internal audit controls, and several other areas including all parts and process of the business.

As important economic entities, SEMs are generally in small scale with simple business nature. Due to resource constraints, they are more likely to focus on single activities. The operations though can often be more flexible and resources allocation could be more efficient.

All these characteristics are generally perceived as an advantage to SMEs. But they can also create certain problems, even be obstacles to have a sound internal control system for SMEs, with consequences as noted above.

Main Problems

Existence of Internal Controls Awareness

For some self-owned small-scale enterprises, the decision-makers do not believe that internal control systems are necessary as long as the business daily management is under direct control of the chief executive.

There are always some implementation issues even when establish internal controls. For example, a considerable number of internal staffs are relatives of business owners or managers, which might lead to an ineffective internal control system, even a potential fraud.

When a business grows though, strong oversight over all aspects of the business becomes more difficult, responsibilities needs to be delegated, and therefore without the right controls in place there is risk. Companies should always be reviewing their internal controls according to the business at that time.

Inadequate Internal Control Systems for SMEs

Many SMEs lack a complete internal control system, which functions have not been implemented in enterprises for all business areas and operations. Below are several examples for reference.

1. A considerable part of a company's financial department still maintains original manual accounting methods accounting procedures are not properly documented, or are using simple accounting systems. Financial information presented could be conflicting with information gathered from operational departments.
2. The financial or accounting department may have only one or two employees responsible for accounting, treasury and financial management. It is difficult to ensure proper segregation of duties due to the limited number of staff.
3. Financial or accounting department is staffed by few relatives who are considered as more trustworthy than outsiders, but they generally lack the required experience and expertise in accounting, treasury and financial management. It is also more difficult to challenge.

Weaknesses of the Internal Control Function for SMEs

The common weaknesses are observed in SMEs internal control, which generally include

1. Proper documentation and employee training are not prepared well enough over the internal control procedures. As such the internal controls cannot be implemented properly or not at all, especially when large staff turnover happens.
2. The monitoring control is required for the implement of SMEs' internal controls. It is an important prerequisite for the personnel review with appropriate expertise.
3. The appropriate review policies are not being carried out.
4. The review is not independent from the practice of internal controls functions. In fact, many SMEs internal control functions are not effective. And they are not able to correctly evaluate the enterprise's financial information or the department performance.

Improving Internal Controls for SMEs

Strengthen the Awareness of SMEs towards Internal Controls

A sound internal control system can effectively improve the management efficiency of enterprises, including SMEs. SMEs should establish a correct understanding of internal controls, using a scientific internal control system in place of simple personnel management to improve the efficiency. Every person involved should be well noted the significance.

Clear Objectives and Purpose of Internal Controls

Internal control objectives are mainly to

- Safeguard assets;
- Ensure the security, integrity and efficient use of a company's assets and resources;
- Enable the provision of reliable and timely management information;
- Reduce unnecessary costs and expenses;
- Ensure the successful implementation and management of various functions to improve the effectiveness and efficiency of business operations;
- Prevent or detect errors, defects and fraud;
- Find the basis for the formulation of management policies and performance of a variety of legal obligations.

Specific targets of each functional department and the internal mechanisms are chosen to ensure proper co-ordination to help achieve the control or business purpose. It requires

- Efficient resources allocation among the departments;
- Various working objectives and work plans communicated to the relevant person in charge to understand the responsibilities of the department's work;
- Various department heads as much as possible should lead by example;
- Enhanced overall coordination of activities by the various departments.

Establish a Sound Internal Control System

The design of an internal control system must follow certain principles. The establishment of a sound internal control system for SMEs could be achieved over a phased period of time. Business owners must be able to see the significance and benefits of having sound internal controls and then efforts can be put into creating a reasonable internal organization structure and segregation of duties. Mutual communication and understanding of various constraints are necessary. In particular, SMEs should pay more attentions to the risky operating cycles, such as procurement and payment, sales and receivables, costs and expenses and other aspects, that are considered as key to business operations.

The philosophy of the business owner or management plays a vital role, in particular for SMEs long-term survival and development. Understanding the enterprise cultural development determines the SMEs direction and content. The establishment of an internal control system will be subject to greater influence for the cultural development of SMEs.

In summary, the majority of SMEs' have ineffective internal controls, whereas most of them have poor awareness of problems in the internal control system, even if those problems are part for the SMEs' developing internal environment. The business environment has become more competitive and complex, and the subsequent ups and downs of the economic cycle seem to occur more frequently than previously and also changing government policies. As the SMEs owners or managers become more aware of their business environment, it is expected that a growing number of SMEs will be willing to allocate resources into establishing sound internal controls.



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Combining years of international expertise with practical Chinese experience and knowledge, LehmanBrown offers expert advice and support to both local and international clients. Within the mid - tier, we are regarded as a market leader and our clients enjoy access to a combination of senior and experienced counsellors from both China and abroad.

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Professional Services

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China Statutory Audit
US GAAP Audit
IFRS Audit
Hong Kong Statutory Audit

Internal Audit

Fraud Investigation
Forensic Accounting

Special Purpose Audit

Foreign Currency Audit
Royalty Audit
Capital Verification Audit

Valuation Services

Corporate Valuation

Damage Assessment Valuation
Intellectual Property Valuation
Asset Valuation
Special Purposes Valuation

Corporate Finance

Debt Restructuring
Acquisition, Disposal & Financing

Mergers & Acquisitions

Transaction Advisory
M&A Divestiture
M&A Integration
Financial Due Diligence

Business Services

Company Registration & Maintenance

Cash Flow Management
Chop Custodian Services
Market Entry Advisory
Updating Company Certificates
Annual Inspection & Reporting
Company Secretarial Services
Company Ownership Transferring/Corporate Restructuring
Background/Credit Checking
Company Deregistration & Bankruptcy

HR Support Services

China Visa Services for Expatriates
Social Welfare Structures

Outsourcing Services

Accounting & Bookkeeping

Budgeting & Forecasting
Financial Statement Preparation
Head Office Reporting

Financial Management

Interim Financial Management
Finance Manager Function
CFO Function

Treasury Management

Set-up of Bank Account

Payroll Services

Payroll Processing Setup
Expatriate Employees
Local Employees

Secondment & Temping Service

Taxation Services

Individual Tax Planning (IIT)

Tax Immigration & Investment Review
US & Overseas Personal Income Tax Planning & Filing
IIT Tax Payment Facilitation
Application for Individual Income Tax Refund
Expatriate Staff Individual Income Tax Staff Filing
Local Staff Individual Income Tax

Company Taxation (CIT)

Tax Consulting

Corporate Tax Planning
Business Restructuring
Value Chain Review
Onshore / Offshore Investment
Transfer Pricing

Tax Compliance

Tax Due Diligence
Tax Deregistration
Negotiation of Tax Penalties
Tax Refund Application
Tax Representatives for Tax Audit
VAT & Customs Duty Clearance
PRC Tax Receipt Verification
VAT Application
VAT & Sales Tax Filing
Corporate Income Tax Reporting

Specialist Accounting & Risk Management

Internal Controls

Systems
Risk Management
Sarbanes - Oxley (SOX 404)

GAAP, SEC & IFRS Compliance

US GAAP

US GAAP Financial Statement Preparation
US GAAP Conversion

Other GAAP

GAAP Conversion
Public Company Compliance
Financial Statement Preparation

IFRS

IFRS Accounting Repackaging
IFRS Financial Statement Preparation
IFRS Public Company Compliance

SEC

SEC Public Company Compliance

Legal Services

Legal Advisory

Labour Legal Advisory

Workforce Downsizing Advisory
Labour Tribunal Assistance & Advisory
Labour Law Review & Audits
Review & Preparation of Employment Contracts

Corporate Legal Advisory

Legal Due Diligence
Corporate Restructuring Advisory
Review & Preparation of Articles of Association (AoA)
Review & Preparation of JV Contracts
Review & Preparation of Repatriation Agreements

Other Legal Services

Dispute Mediation & Advisory
Trademark & Intellectual Property Advisory
Debt Collection Assistance
Litigation Support

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