How Do SMEs Build Internal Audit Capabilities? A Grounded Theory Approach

Jane Zhang and Simon Gao

While recent studies have shown that effective internal audit has a positive impact on a larger firm’s operational performance and corporate governance, it is unclear as to how and to what extent SMEs would benefit from internal audit function and the building of internal audit capabilities. Based on a case study, this article addresses the under-researched issue of internal audit and internal audit capability building (IACB) in SMEs. Using the grounded theory approach we identified the key themes of independence, communications, and staff, resources and training and used the themes to analyze the major issues of internal audit and IACB in SMEs. This case study concludes that the independence of internal auditors has not been recognized by SMEs and SMEs are facing the difficulty to recruit and maintain qualified and experienced internal auditors. Broken communications between internal auditors and other stakeholders have hampered the function of internal audit. There are many obstacles in internal audit practical training, including a lack of qualified trainers, training materials and motivations of trainees. We conclude that the role of cognitive capital is the most important for IACB among SMEs in the construction sector of China.

JEL Codes: M4, M10 and M42

1. Introduction

Small and medium-sized enterprises (SMEs) make a significant contribution to the socio-economic and political infrastructure of a country (Matlay and Westhead, 2005). According to OECD (2004), SMEs constitute 95% of total enterprises in the world and account for 66% of total employment and 55% of total production. A healthy and growing SME sector is perceived to be crucial for sustainable competitive advantage and economic development at local, regional and national levels (Hussain et al., 2006; Porter, 2006). Currently the rising concerns for corporate accountability have been associated with the need for appropriate risk management and internal audit. In the aftermath of several major financial and accounting scandals, stricter governance and internal audit related regulations have since emerged worldwide.

While prior studies have argued that the effective internal audit function has a positive impact on a firm’s operational performance and corporate governance (Lin et al., 2011; Holm and Laursen, 2007; Allegrini et al., 2006; Nagy and Cenker, 2002; Bou-Raad, 2000), how and to what extent internal audit contributes to SMEs’ performance are relatively under-researched. There has been no research looking into the internal audit capability building (IACB) of SMEs. For the purpose of this paper, IACB is defined as the process of enhancing organizational abilities to implement internal auditing to manage risks effectively with a view to attaining organizational objectives.

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Given the scarcity of IACB research in the literature of SMEs, and a seemingly prevalent lacking of the internal audit function in SMEs, this study aims to address the following two research questions: 1) what are the major weaknesses of internal audit in SMEs? 2) what are the major obstacles for SMEs to build internal audit capabilities? The contribution of this paper lies in two distinct areas. First, this is the first study of its kind to address this under-researched area. There is little knowledge about how SMEs implement internal audit and build their internal audit capabilities. Our study sheds some lights on this overlooked issue. Second, this study adopts a grounded theory approach with data from interviews conducted in a construction firm in China. Grounded theory that does not aim for the “truth” but to conceptualize what’s going on provides a unique approach to this under-researched area.

2. Literature Review

The Institute of Internal Auditors (IIA, 1999) defines internal auditing as an independent, objective assurance and consulting activity designed to add value and improve an organisation’s operations. Internal auditing helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes. In order to add value to an organization, the internal audit function must not only make credible recommendations but must also effectively communicate its recommendations so that the organisation’s management will rely on those recommendations. Accordingly, the internal auditors have recently been given bigger responsibilities in strengthening the internal control systems and the risk management procedures (Spira and Page, 2003; Holm and Laursen, 2007) and the role of internal auditors is changing from a traditional audit approach to a more proactive value-added approach where internal auditors are taking up partnerships with management (Bou-Raad, 2000; Leung et al., 2011). Beasley et al. (2005) found that the corporate management had renewed its interest in risk management and developed a new profound interest in internal auditing.

The literature has well recognized the role of internal auditing in enhancing corporate performance, financial reporting and corporate governance (Lin et al., 2011; Mihret et al., 2010; Allegrini et al., 2006; Carcello et al., 2005; Nagy and Cenker, 2002). An internal audit function could be viewed as a “first line defense” against inadequate corporate governance and financial reporting (IIA, 2003). Internal audit can play an important assurance role in an organisation’s governance processes, particularly in the area of risk management and control. The internal audit function can facilitate the processes which enable a business to develop high quality risk assessments (DeLoach, 2000; Walker, Shenkir and Barton, 2002). In many organisations, the expectations placed upon internal audit have increased and the function is being relied on to make a significant contribution (ICAEW, 2004).

Internal audit has a wide range of different stakeholders who rely on its work, including, for example the board of directors, the audit committee, the chief executive officer, the chief financial officer, chief information officer, chief risk officer, etc. All these stakeholders are seeking assurance that the organisation is running well, and that effective controls are in place and operating properly. Internal audit has an important role to play in providing assurance to these stakeholders. In terms of corporate governance, it is argued that an effective internal audit function enables the board to better perform its corporate governance duties. According to the Institute of Internal
Audit, the internal audit function is one of the four cornerstones of corporate governance and has an important role in assisting the board to monitor the effectiveness of its governance (IIA, 2005). By helping the board in this way, internal auditing becomes an essential element of the corporate governance process (Gramling et al., 2004). Leung et al. (2011) argue that if internal auditors are to proactively contribute to good corporate governance, they need to define how, and in what way, this can be done, and they identify issues surrounding internal control, risk assessment and management processes as the key factors for internal audit to contribute to good corporate governance.

Traditionally the internal auditors were acting as ‘policemen’ that check and monitor the company’s procedures and level of compliances with the rules (Skinner and Spira, 2003). Currently the internal auditors can be portrayed as consultants and the internal audit function of companies considered as helping to achieve corporate objectives and add value. As noted by Sarens and De Beelde (2006), the internal auditors are currently expected to make things happen rather than waiting to respond to it. In developed countries, the role of internal auditors has recently been affected by the dramatic changes in regulations, mainly from corporate governance codes/standards and the emphasis of strengthening the internal controls of organisations of these codes/standards (Flesher and Zanzig, 2000; Pass 2006 & 2004; Holm and Laursen, 2007). Investment in internal auditing can add value to an organisation via operating efficiencies, safeguarding assets, more reliable financial statements, and realizing an organisation’s goals and objectives (Feng et al., 2009).

While internal audit objectives have been established with a focus on controls, risks and governance, a recent study by Leung et al. (2011) reveals there is a lack of correlation between the tasks performed by internal auditors and the important internal audit objectives, with the exception of internal control and risks. Their results suggest that internal auditors have been providing an internal consulting and advisory role in matters concerning IT systems, strategic risks and financial issues.

There has been limited research into the role of internal audit in SMEs. This is probably due to the fact that SMEs’ financial reporting has been given less attention and consequently the narrowly defined internal audit that focuses on financial reporting was overlooked. There are only two studies related to internal audit in SMEs. Carey et al. (2000) examine voluntary demand for internal and external auditing by 186 family businesses and find that internal audit was more prevalent than external audit, and outsourcing was a common method for providing internal audit. For firms that voluntarily engaged an auditor (internal and/or external audit), the negative and significant correlation between internal and external audit suggest that in the family business environment they are more commonly viewed as substitute rather than complementary responses. Van Peursem and Jiang (2008) study practices in, and rationales for, internal audit outsourcing in New Zealand SMEs. According to the authors, outsourcing is, perhaps particularly, useful for SMEs requiring expertise as they are resource-poor in general and temporary assistance provides a useful boost. Clearly, there is a lack of understanding of the internal audit function and IACB in SMEs.
3. Methodology and the Case

This study uses an inductive grounded theory building approach (Eisenhardt, 1989; Glaser, 1992) to identify the major issues of internal audit and IACB for SMEs in China as the grounded theory method is effective for under-researched areas where no previous theory exists. The grounded theory approach has been advocated in the literature as a methodology through which to research SMEs (Strauss, 1987; McAdam, 2000). The grounded theory approach involves steps of open coding, selective coding, and theoretical coding (Glaser, 1992). While open coding is “the process of breaking down, examining, comparing, conceptualizing, and categorizing data” (Strauss and Corbin, 1990: 61), axial coding is “a set of procedures whereby data are put back together in new ways after open coding, by making connections between categories” (Strauss and Corbin, 1990: 96). Open coding is the initial stage in data acquisition and relates to describing overall features of the phenomenon under study. This is generally performed by utilizing a coding paradigm involving conditions, context, action/interactional strategies and consequences. Selective coding is “the process of selecting the core category, systematically relating it to other categories, validating those relationships, and filling in categories that need further refinement and development” (Strauss and Corbin, 1990: 116). This process continues until a strong theoretical understanding of an event, object, setting or phenomenon has emerged.

Initially, we used 145 open codes to identify and describe the interview data. After open coding, we followed our designed coding paradigm to rearrange the codes and connect them into 11 distinctive categories (selective codes). Finally, we categorized them into three themes (independence, communication, and staffing, resources and training) that were reported in the next section.

The main method for collecting data was through semi-structured interviews that were of an open-ended nature, including interviews with owner/managers, human resources managers, management accountants, internal auditors, and site managers, together with government officials from local SMEs administrations. 35 interviews were conducted in total by one of the authors over a period of six months from April to September 2010, out of which eight interviews were carried out in the case firm reported here. The details of the interviews are shown in Table 1. The major data collection was also accompanied by a brief questionnaire. The purpose of the questionnaire was to collect demographic data such as the age, gender, and educational background of interviewees, as these demographics can be relevant to the organizational ability of implementing internal audit and building internal audit capabilities.

Table 1 Summary of the interviews conducted in the case firm.

<table>
<thead>
<tr>
<th>Type of interviewee</th>
<th>Date and duration (min)</th>
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</thead>
<tbody>
<tr>
<td>Owner/manager</td>
<td>05 April 10 (65)</td>
</tr>
<tr>
<td>Corporate training manager</td>
<td>05 April 10 (55)</td>
</tr>
<tr>
<td>Deputy HR manager</td>
<td>06 April 10 (55)</td>
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<tr>
<td>Management accountant</td>
<td>08 April 10 (60)</td>
</tr>
<tr>
<td>Internal auditor</td>
<td>08 April 2010 (55)</td>
</tr>
<tr>
<td>Head of accounting</td>
<td>25 June 2010 (50)</td>
</tr>
<tr>
<td>Site manager</td>
<td>26 June 2010 (55)</td>
</tr>
<tr>
<td>Risk and safety officer</td>
<td>27 June 2010 (60)</td>
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</tbody>
</table>
The case company reported here is one of thousands of construction firms operated in China. During the past two decades of China’s economic growth, the huge expansion of infrastructure and housing development has led to the strong development of small and medium-sized construction firms and associated businesses. Apart from general business risks consisting of operating, financial and reputation risks faced by SMEs, the construction sector also exposes many additional risks associated with accidents, safety, environment and regulations (Davis and Walker, 2009). Our construction firm case is not claimed to be a structured, representative sample of SMEs. Given the difficulty of engaging small businesses in research (Curran and Blackburn, 2001), a convenient case was chosen due to prior research links and personal contacts. Some prior studies (e.g., Hutchinson and Quintas, 2008) have used convenient cases for SMEs qualitative research.

Case firm

Firm S was founded in 1991 by Wu family in Village W in Jiangdu city, Jiangsu province, China with the total registered capital of just over 2000 RMB (less than US$300). Over the period of two decades, S had developed significantly with the value of assets at over 660 million RMB (over US$100m) by the end of 2010. Initially, S was a township enterprise providing decorating and door-fitting services. Jiangdu is just about 160 miles away from Shanghai and 60 miles from Nanjing (the capital of Jiangsu); this geographical convenience provides an excellent opportunity for S to get some business from the booming of both Shanghai and Nanjing. The firm realized that while decorating and door-fitting business can help to survive and generate good return, but it cannot be the firm’s future direction. The family decided to expand its operation to construction and property development business with a focus on Jiangdu first and then to Jiangsu for the reason that there was an opportunity to build country-house and holiday homes for wealthy people from Shanghai and Nanjing. Also, Jiangdu, as a new city in Jiangsu, was given many privileged policies, including the transfer of agricultural lands into housing estate, and bank loan supports.

In 2003, S began to diversify its business into other related sectors, including construction, property management, transport, and infrastructure and logistics services. A lack of skilled and qualified people hampered S in its effective management of the diversified business. Similar to all the construction firms, most employees of S have to travel to many construction sites, away from family and friends, with difficult working conditions, low income, low skill utilization, and virtually no prospects for training. S had an annual staff turnover of over 20% on average and over 30% for the middle managers in 2005. Since 2003, risk has increased across the whole firm, reflecting in a variety of areas including increasing accidents and bad debts, confrontations from local residents, the shortage of workers, and rising uncertainties with lenders. The managers had very limited knowledge about the internal audit function and there was a lack of communications within the firm concerning the role of internal auditors and the function of internal audit.
4. Findings

The findings are based on our grounded theory analysis of the data that examine the internal audit problems and difficulties of building internal audit capabilities in the case firm.

**Independence.**
The IIA’s International Standards for the Professional Practice of Internal Auditing state that independence is the freedom from conditions that threaten the ability of the internal audit activity to carry out internal audit responsibilities in an unbiased manner. To achieve the degree of independence necessary to effectively carry out the responsibilities of the internal audit activity, the chief audit executive has direct and unrestricted access to senior management and the board. This can be achieved through a dual-reporting relationship. Threats to independence must be managed at the individual auditor, engagement, functional, and organizational levels. In the case firm, independence was not widely recognised because most employees were related to each other and had social and family connections with village W. The Standards proclaim that the internal auditor occupies a unique position he or she is employed by the management but is also expected to review the conduct of management which can create significant tension since the internal auditor’s independence from management is necessary for the auditor to objectively assess the management’s action, but the internal auditor’s dependence on the management for employment is very clear. In the case firm, three internal auditors who were appointed a few years ago were the relatives of the owner and senior managers. It was widely understood among the employees that they were working mainly on behalf of the owner and the senior managers. The primary responsibility of these internal auditors was to identify the problems and potential risks of individual construction sites as well as potential financial irregularities and frauds among middle-ranked and line managers and to report them to the management team. Independence was commented by an interviewee:

“It is a joke to talk about independence in China. The core value of our society is guangxi. This also applies to our firm and to our internal auditors. I knew a few years ago we had one internal auditor who actually was a relative of one of our senior manager. The person left us and got a big job.” (Site manager)

**Communication**
Communication is the exchange and flow of information and ideas from one person to another. It enables all actors to share and exchange beliefs, values and views (Sabel, 1994). Communication is a process of social interaction with the object of mediating between different actors involved and establishing common codes. In IACB communication is considered the key to establishing and strengthening relations between internal auditors and a variety of stakeholders. This is because the process of communication can strengthen a better understanding between the auditors and stakeholders of risk, corporate governance and financial information, and create spaces for internal audit functioning. As highlighted by the owner, “we see communication is vital to the effectiveness of our risk management, and ultimately to the success of our company”. In SMEs an increased emphasis on risk management has a potential to place the internal auditor into a more focused position. Many firms, including the case firm, are increasingly looking to their internal auditors to give guidance and advice at all levels of management. Indeed, an advisory role provides senior management with the
added support to decision making issues and problems that ensure the achievement of organisational goals.

In S, the geographic separation of construction sites, together with their dependence on telephone as the main channel of communication formed a major barrier for developing a formal internal audit system and communicating between the internal auditors, other professionals and senior managers. Lack of communication creates caveats for understanding the role of internal auditors and sharing internal auditing practice within the firm and across the industry in general. As commented by a number of interviewees, collaboration and learning are concepts hardly in existence within the construction industry.

Indeed, the ability of internal auditors to establish effective relationships with other stakeholders through communication as well as the capacity to access to and distribute information is highly relevant. However, asymmetries regarding the access to and use of communication in Firm S between different stakeholders had actually complicated the communication process. On the one hand, employees were not informed about the role of internal auditors and their responsibilities and potential contributions in the firm. The internal auditors were wrongly seen as management’s spy and most employees had a negative attitude toward the internal auditors. On the other hand, most of the information transmitted and disseminated is much more financial information and data, which is of little useful to many actors as most employees had difficulty to understand them. On the whole, the information and communication structure of firm S was not effective. A formal information exchange system did not exist. Indeed, missing communication and poor exchange of information and knowledge have impacted directly on the effectiveness of creating and enhancing the ability for Firm S to develop and implement internal audit.

Staffing, resources and training
The construction industry was perceived as “dirty, unpleasant, and third-class” with most of the employees coming from countryside with low/no qualifications. Well educated people are reluctant to work for Firm S and this restricts the opportunities for learning and knowledge transfer via an educated and trained workforce. New university graduates mainly came to gain some work experience and then left after two/three years. As S had high staff turnover, this had a major impact on the continuity of internal audit functioning. Two members of staff who joined the firm four years ago specifically for the establishment of an internal audit system and risk management have left the firm. S had some difficulty to recruit experienced and qualified personnel to fill the posts. A human resources manager explained:

"We have tried to recruit a few internal auditors with working experience; but every time we only received applications from new graduates. They do not have any experience. We cannot offer any training to them. For a firm likes us, we need experienced people to help us to set up the system and operate it immediately".

Internal audit needs to have adequate budget and resources to complete its work plan and fulfil its remit. In the case, financial resource was not a major problem as the firm had committed to the development of an internal audit system with sufficient budget. To enable internal audit to function, it will need to have staff with the right skills and
expertise. This has been a major problem as noted before. The firm S had some difficulty in recruiting qualified internal auditors with working experience.

Formal training was widely considered a “waste of money” as low cost is the key to a firm’s competitiveness in the construction sector. While the case provides ample evidence to indicate that training would play a decisive role in understanding the internal audit function, there were some major problems in promoting internal audit awareness and improving employees’ risk management knowledge in Firm S. Like any other construction firm, Firm S had employees with a lack of proper education and training. Most part-time and casual workers were directly recruited into the firm from poor rural areas and they were formerly farmers. The case firm shows a poor understanding of internal audit among its employees and managers. Insufficiency of internal audit understanding and lacking of professional auditors impeded the case firm to implement a formal internal audit system within the firm. While in China, there is no requirement for internal audit to be provided by a firm’s own employees, the case firm was reluctant to outsource internal audit service, “not because of financial implications, but due to lacking of guangxi with an external provider” (Management accountant).

Internal audit was considered to provide a pro-active value added service (Stewart and Subramaniam, 2010). Changing stakeholder expectations and a new view of risk management are prompting an important shift in the role of internal audit in many organizations, including SMEs (Soh and Martinov-Bennie, 2011). The change in focus to a value creation approach requires a change in audit focus and a corresponding requirement for internal auditors to acquire new skills through learning and training. The responsibilities of internal auditors are expanding and, consequently, the required skills are changing. With a risk management focus, internal audit can move beyond its monitoring role to help influence and improve how risks are managed before they become challenges. This is particularly relevant to the case firm as rising risks and incidents have had a major impact on the firm’s competitiveness and the firm has some difficulty to follow the rapid changes of regulations and standards. Internal audit can look beyond compliance to helping the organization improve overall business performance. Both the head of accounting and HR manager agreed that there was a need for more staff training. However, they felt that the training required was that of a combination of internal audit theory reinforced by practical on the job training. The head of accounting commented:

“As audit has evolved since 1980s due to the development of techniques, such as computer-based auditing, that have built on past knowledge and experience and as such the audit itself has changed. Training becomes very important. However, our sector has some uniqueness which requires a good understanding of our business. Job training and training on the sites are even more important.”

While the importance of training has been recognised, there were many practical issues in the delivery of such training, including a lack of qualified trainers, suitable training materials and motivations of trainees. The case firm tried to invite professors at a local university to be the trainers, but found out none of them had any practical experience. Most auditing textbooks were for university and college students with a focus on theories and basic audit knowledge with no real case from the construction industry. From the perspective of trainees, particularly of those young graduates in the area of business management and accounting, they did not well value such training as many of
them did not see their current jobs as a long-term career. There was a lack of interest of taking part in the training from potential internal auditors and other relevant professionals.

5. Conclusion

In this study we have identified major issues of internal audit and IACB for SMEs in China. We use the grounded theory approach to identity three key themes (i.e., independence, communications, and staff, resources and training) that could help to understand the enables and obstacles of developing internal audit and building internal audit capabilities for SMEs. Basing on the evidence from the case firm we find that the independence of internal auditors has not been recognized by SMEs and SMEs are facing the difficulty to recruit and maintain qualified and experienced internal auditors. Broken communications between internal auditors and other stakeholders have hampered the function of internal audit. There are many obstacles in internal audit practical training, including a lack of qualified trainers, training materials and motivations of trainees. We conclude that the role of cognitive capital is the most important for IACB among SMEs in the construction sector of China. This is because IACB is intimately linked to knowledge and skills at the level of human resource development that is a crucial issue for SMEs (Pollard and Svarcova, 2009; Kock and Ellström, 2011). We believe our findings are relevant to the study of IACB in SMEs in other developing countries, but obviously national context needs to be taken into account as there are significant differences in institutional environments and national economic and cultural attributes. We see a need for more research in the area of internal audit and IACB in SMEs.

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