

# Internal control in the real estate industry and its financial risk management

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**Abstract:** *In recent years, with the rapid development of China's economy and the dynamic changes in housing policies, China's real estate enterprises are facing severe challenges while flourishing. In order to ensure the future sound development of real estate enterprises, enterprises need to deepen their own internal control system and do a good job in financial risk management. From the perspective of internal control and financial risk management, this paper aims to analyze the shortcomings of real estate enterprises in internal control and financial risk management at the present stage and put forward corresponding countermeasures and suggestions in order to help enterprises improve their management level and achieve long-term development.*

**Keywords:** *Real estate companies; Internal Control; Financial Risk Management; Risk Prevention*

## 1. Introduction

In the context of China's post-epidemic era, the national and local governments have introduced many restrictive measures on the real estate industry in order to reduce the growth rate of housing prices and promote the stable and healthy development of the real estate market, which, coupled with the deepening national awareness of property value preservation and appreciation, has caused the real estate industry to suffer a considerable impact and the industry development form is not optimistic. In the face of the highly dynamic and uncertain environment, the real estate industry needs to strengthen internal control management, especially the risk of financial internal control, optimize the financial risk management mechanism, strengthen the ability to identify and respond to risks, and minimize the impact on the development process of enterprises. From the perspective of financial management, this paper aims to analyze the causes of the internal control and financial risk problems currently faced by the real estate industry and propose corresponding optimization strategies to promote the sustainable operation and stable development of real estate enterprises in the difficult situation.

## 2. Overview of internal control and financial risk in real estate companies

### 2.1 Definition of Internal Control

Internal control is a series of methods developed by enterprises to safeguard the legitimate management of enterprises and to improve the efficiency of their operations. By setting up various management methods, enterprises can improve their ability to operate in a refined manner, further strengthen their internal control management and improve their risk prevention capabilities. Internal control of enterprise finance is a financial control enforced by enterprises using relevant administrative authority and regulations to ensure the quality and efficiency of the internal financial work of enterprises, and to control and restrain relevant financial personnel through regulations to avoid internal financial problems of enterprises [1].

### 2.2 Definition of financial risks

Financial risk is the concentration of enterprise operation risk. Financial risk in a broad sense refers to the financial risk that may occur in all aspects of the enterprise's production and operation process, covering a very wide range, including investment decisions, procurement, production, sales and other aspects. Financial risk in a narrow sense, also known as financing risk, refers to the possibility that an enterprise will not be able to repay its liabilities at maturity due to borrowed funds, and the risk of increased fluctuations in net profit due to the use of financial leverage. In short financial risk is the

behavior of an enterprise in financial activities due to the existence of various uncertainties that lead to deviations between the financial earnings of the enterprise and the expected earnings. However, the financial risk of the enterprise is objective in nature, and the enterprise cannot completely eliminate the financial risk, but can only reduce the probability of its occurrence by taking effective financial management measures to eliminate the risk with the least loss and the fastest way to ensure the normal operation of the financial mechanism.

### ***2.3 Internal control of real estate enterprises***

Real estate internal control refers to the use of modern information management technology in real estate enterprises, combining comprehensive and local methods, and adopting diverse accounting management methods to strictly supervise and control the business joints within real estate enterprises. Real estate enterprises usually face extremely high risks in the process of operation and management, and the high risks are influenced by various factors, such as: real estate development projects with large investment amounts, long construction cycles and high risks, the real estate industry itself is significantly affected by the national macro-control policies, certain real estate enterprises have not yet formed a clear cognition of internal control of real estate enterprises, the real estate industry is becoming increasingly saturated and market competition is becoming increasingly fierce. The perfect internal control system can promote the refinement of real estate enterprise management, improve the overall competitiveness and maximize the economic benefits of real estate enterprises.

### ***2.4 Real estate enterprise financial risk***

In essence, real estate financial risk is a microeconomic risk and a concentrated risk in the economic activities of enterprises. Real estate financial risk in a broad sense is the financial work of the enterprise is affected by uncertainties, resulting in a certain difference between the actual earnings and expected earnings of the enterprise's finance, specifically including refinancing risk, investment risk, debt risk, interest rate change risk, etc. These risks are prone to bring some economic losses for real estate enterprises, which are not conducive to the long-term development of real estate enterprises. In a narrow sense, the financial risk of real estate enterprises mainly includes the risks related to financing and debt, which are only related to the liabilities of real estate enterprises, that is to say, when real estate enterprises do not undertake any debt, there is basically no financial risk.

Whether from a narrow or broad perspective, the results of the realistic existence of financial risks of real estate enterprises are affected by a variety of factors that are difficult to control or uncertain, resulting in deviations from the expected operational goals of the final financial results obtained by real estate enterprises over a period of time and within a certain range, mainly in the form of great economic losses or reduced economic returns for real estate enterprises [2].

In summary, based on the existing literature and theories, this thesis will discuss some urgent problems exposed in the real estate industry from two perspectives of internal control and financial risks in the real estate industry, aiming to provide some suggestions and references for the better development of the real estate industry.

## **3. Case Analysis**

### ***3.1 Take the Country Garden as an example***

Country Garden is the largest developer of new urbanized residential properties in China. The Group adopts a centralized and standardized operating model, and its diversified businesses include property development, construction and security, renovation, property management, property investment, hotel development and management, and education business[3].

In order to keep up with the dynamic changes in the market, Country Garden entered into a shrinking and streamlining stage, adding city companies between regions and projects, and carrying out four levels of control, while making other organizational restructuring. Entering 2020, Country Garden made two more major organizational restructuring, first by merging some regions and then by carrying out regional fission. Whether it is flexible expansion following the footsteps of the market, or contraction and streamlining under the tight market, Country Garden has demonstrated its flexible and changeable organizational system.

In addition, the reason why Country Garden can repeatedly get out of crises also relies on its mature and scientific large financial management and risk prevention and control system. The finance of Country Garden is a "big financial management" that integrates vertical and comprehensive management. It includes fund management, accounting management, tax management, legal management, return target management and so on. The scientific management concept and mature financial risk control system have given Country Garden a strong anti-risk capability, and it is able to cope with industry uncertainties with ease.

Country Garden has established a good risk awareness, built a systematic internal control system and financial risk control system, and built a firm line of defense for corporate security, which has enabled the company to show its strong strength and continuous and steady development momentum.

### ***3.2 Take Evergrande Group as an example***

Evergrande Group was founded in 1996 in Guangzhou, Guangdong Province and listed on the Hong Kong Stock Exchange in 2009. Evergrande Group was once the leader in standardization of real estate operation in China and ranked among the top 500 in the world. The Group owns eight industries, namely Evergrande Real Estate, Evergrande New Energy Vehicle, Evergrande Property, Everton Network, RV Treasure, Evergrande Kid's World, Evergrande Health and Evergrande Ice Spring. Evergrande Group expects to achieve a total asset holding of 3 trillion yuan by 2022, with annual sales of up to 1 trillion yuan and annual profits and taxes of 150 billion yuan, ranking among the top 100 enterprises in the world [4].

However, since the second half of 2021, Evergrande began to experience a huge financial crisis, with the group's debt of 1.97 trillion yuan and a broken capital chain, which was subsequently taken over by the government. A giant head enterprise was instantly the building was falling down and almost on the verge of bankruptcy and liquidation. From this, we can see that there are great loopholes in the internal control system and financial risk control of Evergrande Group. Its financial risks are mainly divided into three aspects, which are investment risk, revenue distribution risk and capital recovery risk. In addition, the fact that Evergrande Group is on the verge of bankruptcy and liquidation also reflects the imperfection of its internal control mechanism. Evergrande Group has been actively adopting diversified development strategy since its listing in 2009, but the expansion of diversified business has not created greater value for the enterprise, which is due to the problem of improper operation and management within Evergrande Group, the Group has not conducted sufficient market research and analysis, and blindly selected diversified fields, resulting in deviation of industry positioning, and the Group's ability to adapt to industrial environment and market survival. Obviously cannot follow up, which seriously affects the Group's sound development.

### ***3.3 Summary***

By comparing two head companies in the real estate industry, namely, Cinnamon and Evergrande, the author verifies the importance of a sound internal control system and a complete financial risk management mechanism for real estate enterprises. Facing the highly dynamic and uncertain environment of the industry, real estate enterprises can only be always invincible in the competition by establishing good risk awareness, building a systematic internal control and financial risk control system, building a firm defense line of corporate security and enhancing the anti-risk capability of the enterprise.

## **4. Analysis of the problems in internal control of real estate enterprises**

In the face of the new requirements in the new era, many real estate enterprises still have a lack of awareness of the importance of internal control from the general grassroots staff to the managers, the business processes of internal control are not sound enough, the relevant system is lacking, the internal audit organization is less independent and cannot play its role at all, and the information exchange and communication between internal and external enterprises are poor, resulting in The internal and external information exchange and communication are poor, resulting in a series of problems such as business hindrance and inefficiency [5]. Specifically, they are mainly manifested in the following aspects:

### ***4.1 Lack of a solid environmental foundation for internal control in enterprises***

Most real estate enterprises have difficulty in carrying out internal control work because many real

estate enterprise managers lack systematic understanding of the implementation of internal control and employees are resistant to the construction of internal control system. Some enterprise managers believe that internal control management is not practical, but rather detrimental to the sound development of the enterprise; at the same time, enterprise managers may believe that the implementation of the internal control system is difficult to bring a greater positive impact on the production and operation of the enterprise and profit, but will increase the management cost of the enterprise, which is more than worth the loss. Some employees of real estate enterprises believe that internal control theory is too complicated and cumbersome and are unwilling to add extra workload to learn new theoretical knowledge [6].

#### ***4.2 Lack of a sound system of internal control of enterprises***

At present, some real estate enterprises in China are in a period of rapid development but ignore the importance of the construction of internal control system, believing that real estate enterprises can survive in the long run as long as they do a good job in land development and project construction, and simply do not need to invest too much energy in the level of internal control. At the same time, enterprises that are aware of the importance of internal control systems lack the rationality and operability of internal control models due to the lack of relevant experience to support them. For example, in the process of building internal control systems, some real estate enterprises do not sort out the needs of business operation and internal control of engineering projects, resulting in unclear authority and responsibility between departments and unreasonable division of labor, which reduces the efficiency of business operation.

#### ***4.3 Lack of strength in the implementation of internal controls in enterprises***

From the current point of view, real estate enterprises still lack implementation efforts in internal control. For example, some of the managers of real estate enterprises have low cultural quality and lack relevant experience in internal control, and only rely on their own experience for process design, which leads to a lack of operability of the final internal control process and seriously affects the implementation of the internal control system.

#### ***4.4 Lack of a sound risk assessment system for enterprise internal control***

As a typical high-risk industry, the real estate industry has certain risks in all aspects of the business management process, and the characteristics, manifestations and degrees of impact of the risks vary [7]. However, at present, some real estate enterprises still lack a perfect risk assessment system and ignore the important impact of risk assessment on real estate enterprises. In real estate development enterprises, they are vulnerable to the influence of national policies because of their long development cycle and the need to invest a large amount of costs at one time. If a real estate development enterprise lacks a perfect risk assessment system, the development of the enterprise will face a devastating blow in the event of unexpected problems, which is not conducive to the sound development of real estate enterprises.

### **5. Analysis of the problems in financial risk management of real estate enterprises**

#### ***5.1 The construction of enterprise financial management talent team needs to be strengthened***

In the traditional operation and management of real estate enterprises, financial managers are mainly responsible for the accounting and analysis of financial data. Due to the lack of awareness of financial risk management in some real estate enterprises in the past, the awareness of responsibility of the financial managers is not strong. In addition, because enterprises focus on business development, they do not pay enough attention to the training of enterprise financial management personnel, resulting in their own financial management personnel's ability to work and quality level cannot be effectively improved. The construction of enterprise financial crisis early warning system has higher requirements for enterprise financial management personnel, but the quality and ability level of some financial management personnel of real estate enterprises are far from meeting the needs of the construction and application of enterprise financial crisis early warning system, which is not conducive to the progress and sustainable development of real estate enterprises in the new situation.

## ***5.2 Lack of a sound financial control system in the enterprise***

The characteristics of highly indebted operation of real estate enterprises require real estate enterprises to have a sound financial monitoring system. However, at present, the financial monitoring system of many real estate enterprises has many problems such as weak awareness of financial risks, single financing structure and low level of financing management, which may lead to the blind use of funds in the daily operation activities of enterprises and cannot give full play to the maximum utilization value of funds, which is not conducive to the healthy growth of enterprises.

## **6. Measures to prevent internal control and financial risks in real estate enterprises**

At this stage, China's real estate enterprises still have a series of problems and deficiencies in their own internal control and financial risk management, which seriously affect the improvement of the level of financial management of real estate enterprises. This paper puts forward the following improvement measures for real estate enterprises to improve their own problems.

### ***6.1 Optimize internal control of real estate enterprises***

#### ***6.1.1 Raise awareness of internal control among all staff***

To improve the internal control of real estate enterprises, first of all, the top management should be professionally trained in internal control, make them familiar with the internal control system and framework, plan strategic goals for the enterprise based on the understanding of the system, clarify how to implement internal control into project development, promote the formation of a unified internal control atmosphere within the enterprise, lead the staff in the construction of internal control for the whole staff, and improve the internal control system from top to bottom[8]. At the same time, it is also necessary to strengthen the attention of all employees to internal control, hire experts to conduct training on internal control theory and practice for personnel related to internal control in enterprises, update the knowledge base of internal control personnel in a timely manner, and assess the results of the training and link the assessment results to the salary performance of internal control personnel to motivate employees to learn.

#### ***6.1.2 Improve internal control execution***

The internal control system is of great significance to improve corporate management and competitiveness. To improve the execution of the internal control system, we can start from the following aspects: (1) construct a company management culture of reverence for the system, the execution of internal control and reverence for the company's system depends first of all on effective corporate governance and on the exemplary role of the company's senior management in implementing the internal control system. (2) give full play to the synergy of internal and external supervision, the formation of corporate "self-restraint" mechanism, internal supervision can be achieved through the establishment of a sound corporate governance structure, system supervision, budget supervision, accounting supervision, internal audit supervision and other forms, external supervision can be achieved through the Ministry of Finance, the Securities and Exchange Commission, accounting firms and other forces. (3) Establish good information communication (3) Establishing a good information communication mechanism, dealing seriously with false information, delayed information and misleading information, ensuring the truthfulness, timeliness and error of information transmission, so that the operation of internal control links have a basis for judgment, thus effectively controlling management risks.

#### ***6.1.3 Improve the quality of the talent team***

Internal control construction is a long-period, wide-ranging system project, and in order to develop an internal control system that meets their actual development, enterprises should pay attention to the cultivation of talents [8]. Enterprises should establish an in-depth talent management system and talent career planning, change the traditional development concept of seeking rapid growth of performance in the short term, strengthen talent strategy, optimize the compensation, reward and punishment system and welfare system, reduce the brain drain of enterprises, and cultivate high-level management talents for internal control to promote the continuous progress and development of enterprises.

## **6.2 Preventing financial risks of real estate enterprises**

### **6.2.1 Optimize capital structure**

In the process of financing, real estate companies can optimize their total capital structure through the following measures. (1) Reduce the gearing ratio to enhance the profitability of the enterprise. (2) In the process of real estate development and investment, help companies reduce land purchase costs and improve their earnings by optimizing land investment decisions. (3) Improve the internal inventory management mechanism, develop reasonable sales plans to promote inventory turnover efficiency. (4) Develop diversified industries. Facing the highly dynamic and uncertain environment of the industry, the development of infrastructure, finance and other industrial clusters.

### **6.2.2 Establishing a sense of the big picture**

The operation of an enterprise requires a lot of money and time, and if the management of the enterprise lacks a sense of the big picture and foresight, all the investments made by blind investments, blind expansions, blind loans, blind mortgages, and not according to the actual situation of the market and the actual situation of the company, are making a needless waste. It will greatly consume the reputation of the enterprise in the society [9]. Real estate enterprises should take the initiative to maintain market stability, determine reasonable sales prices, develop scientific promotion programs, refrain from vicious competition by unjustified means, and firmly establish a sense of the overall situation of maintaining the stable and healthy development of the real estate market.

### **6.2.3 Establish a sound financial risk warning mechanism**

Real estate enterprises should build a perfect financial risk early warning mechanism with the help of advanced information technology according to their operation status, so as to timely find out the problems existing in the actual operation and management process and propose solutions to specific problems, thus reducing the incidence of various types of risks. In the process of identifying different types of capital flow risks, the cash flow of real estate enterprises is taken as the core, and the basic situation of budget implementation is observed, analyzed with the help of budget variances and existing abnormalities, and scientific solution strategies are proposed. In this way, the normal operation of the financial flow is ensured, the safety and effectiveness of the financial system is ensured, and the key decision basis for the preparation of long-term development plans is provided[10].

## **7. Conclusion**

In summary, in the face of the highly dynamic and uncertain economic situation of the real estate industry, real estate companies urgently need to enhance the importance of internal control and financial risk management, analyze possible internal risk hazards, and avoid risks through effective initiatives to enhance the comprehensive competitive strength of real estate companies and promote their sound development.

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