

THE INTERNATIONAL JOURNAL OF BUSINESS & MANAGEMENT

Relationship between Internal Control Systems and Effective Management of Small and Medium Size Enterprises in Uasin Gishu County, Kenya

Judith Jebichii Tuwei

Doctorate Degree Student, School of Human Resource Development,
Jomo Kenyatta University of Agriculture and Technology, Nairobi, Kenya

Latoya Cheptoo Berege

Doctorate Degree Student, School of Human Resource Development,
Jomo Kenyatta University of Agriculture and Technology Nairobi, Kenya

Abstract:

This study sought to examine the effectiveness of internal control systems among the small and medium size enterprises in Uasin Gishu County, Kenya. A cross sectional descriptive survey design was used. Data was gathered using a self-administered structured questionnaire. The study was carried out using simple random sampling to get 120 respondents among list of all the SMEs in Eldoret Municipality. Data from the research instruments were analyzed using Statistical Package for Social Scientists. Analysis output included; Descriptive statistics (means, standard deviation, frequencies, percentages and factor analysis), and inferential statistics (correlations, and regressions). The findings of the research enabled the emergence of a theory grounded in the collected data. Indeed, the major features of an effective internal control system applicable for SMEs are found to be sound effective environment, risk assessment process, operational control activities, information and communication system, effective monitoring and evaluation system. All the constructs of Internal Control Systems (Control Environment, Control Activities, Risk Assessment, Information and Communication and Monitoring) have a significant positive relationship with the operations of SMEs in Eldoret Municipality. This implies that the more effective the ICS, the more the ICS are adhered to, the high the chances that SMEs will achieve their objectives. The study highlights the importance of having a sound standardized internal control system in SMEs and its major roles. The research emphasizes on the fact that lack of proper understanding of the value of effective internal control in SMEs usually leads to inefficient system of internal control in SMEs. This study is believed to contribute to the effort of implementing effective internal control systems in Eldoret Municipality SMEs

Key words: *Internal control systems, small and medium size enterprises, effective management, control environment, control activities, risk assessment, information, communication, monitoring*

1. Introduction

In Kenya, considering these various definitions regarding small business enterprise for official policy decision by the government, emphasis has been placed on the higher limit of capital investment and number of employees. There has been no attempt made so far to stipulate the low limit that can qualify an establishment for government recognition as small scale enterprises for the purpose of credit facilities in Kenya. In Kenya, SMEs have fewer than 50 employees and formally registered entity with between 5 and 50 employees, a turnover below US\$ 5 million (Kshs. 425 million), and net assets below US\$100,000 (Kshs. 8.5 million). All enterprises in Kenya with fewer than 250 employees are categorized as medium size enterprises (OECD 2005). SMEs constitute currently the major part of economic activities in the Kenya. Nowadays, they represent about 90% of all types of enterprises in Kenya and provide high job opportunities to its labour force (Waweru, 2007). Internal control is a means by which resources of these SMEs are directed, monitored, and measured. It plays an important role in preventing and detecting fraud and protecting the physical and intangible resources; moreover, it leads to high efficiency of the business operation. Therefore, unless they have strong internal control system to monitor and run their businesses, the prospect of bankruptcy threatens each and every SME (Sampson, 1999).

According to a survey by KPMG in 2001/02 internal controls are one of the means by which risk is managed in an organization. It is considered to support employees in the achievement of the organization's objective by responding to significant business, operational, financial, compliance and other risks (CIMA, 2005). Therefore, focusing on this business area is a timely issue and a rewarding one since it contributes a lot for the majority of business enterprises involved in SMEs. The availability of this data can be a helpful to improve the overall efficiency of business enterprises involved in SMEs. In doing this, a study was conducted using SMEs within Uasin Gishu County, Kenya.

2. Statement of Problem

In Kenya, foremost among problems identified with private organizations in recent years has been the inefficiency and ineffectiveness of their Internal Control Systems. Auditors of accounts of such private organization have continually expressed concern about this bad state of affairs; and have therefore strongly recommended the establishment of measures to ensure adequate financial discipline. This study sought to examine closely, the nature and form of internal control systems of small and medium size enterprises in Uasin Gishu County, Kenya and also to ascertain the weakness in the system. The primary focus, then, was the evaluation of the internal control systems put in place by the management of the SMEs, to ensure the proper, economic and efficient use of resources in attaining their set objectives.

2.1. Purpose of the Study

The main objective was to examine the effectiveness of internal control systems among the small and medium size enterprises in Uasin Gishu County, Kenya. Three specific research objectives were addressed;

- To identify the Internal Control Systems of SMEs Uasin Gishu County, Kenya
- To establish the perception of SMEs owners on the contribution ICS to the management of SME.
- To identify the main components of effective internal control systems that SMEs performance in Uasin Gishu County, Kenya
- To find out the extent at which internal control system of SMEs comply with the principles of effective internal control

3. Research Methodology

This study utilized a cross-sectional survey design based on a sample drawn from locations of SMEs that cut across the Uasin Gishu County, Kenya. Descriptive research design was chosen because it is efficient in collecting large amounts of information within a short time. The study population comprised 1785 SMEs out of which a sample size of 122 respondents was chosen from each of the two strata of SMEs i.e. services and manufacturing. The instrument used to collect data for the study was questionnaire. The content validity was determined by multiple sources of information and chain of evidence. The reliability of instrument was determined using the test-retest reliability techniques. The data collected were analyzed using Descriptive statistics (means, standard deviation, frequencies and percentages).

4. Results and Discussion of Research Findings

In order to examine the effectiveness of internal control systems among the small and medium size enterprises in Uasin Gishu County, Kenya, the Statistical Package for Social Sciences (SPSS version 21) windows was used to derive for the descriptive statistics. The analysis and interpretation of the findings was in relation to the study objectives.

4.1. The Internal Control Systems of SMEs in Eldoret Municipality-Kenya

The Internal Control Systems that SMEs actually performs are presented in the descriptive statistics shown by the values of the respective means and standard deviations. Details of this analysis are shown in table 1 below.

	N	Min	Max.	Mean	Standard Deviation
Accounting & Financial mgt system	120	2	5	4.08	0.882
Management Commitment	120	2	5	3.71	0.984
Management's close Monitoring	120	2	5	3.24	0.943
Management providing feedback	118	1	5	2.78	1.004
Correction of errors in the system	120	1	5	3.21	0.935
Management Integrity	120	1	5	3.29	1.137
Ethical values	120	1	5	3.11	1.034
Independent audit committee	120	1	5	3.08	1.124
Council independence and its committees	120	2	5	3.66	0.878
Valid N (list wise)	118				

Table 1: Internal Control Systems of SMEs

The study (as reflected in table) found that the respondents seem to agree that the SMEs has an accounting and financial management system in place with a mean value of 4.08 and standard deviation significant value of 0.882 which appears to be close to the maximum rank of 5. From the table 1 above, respondents seemed to agree that management is committed to the operation of the Accounting and Financial management system as reflected by the mean value of 3.7 which is tending towards the maximum point of 5 and a significant standard deviation of 0.984.

Also, respondents provided their understanding in regard to how management closely monitors implementation of the controls and their perceptions show mean of 3.24. Thus, a standard deviation of 0.943 suggests significant differences in responses as regards management's monitoring of implementation of internal control system. The results as reflected in table 1 show a mean of 2.78 that is below the mean average, implying that respondents disagree as to the statement regarding feedback. Consequently, a greater standard deviation figure of 1.004 raises concerns regarding the feedback given to junior officers.

The results suggest that respondents seem to agree that appropriate action is normally taken by management to correct irregularity in the operations of the system, although the standard deviation of 0.935 suggests that they possess varied understanding about the aspect of the measures taken to correct any weaknesses in the controls. Also, the results suggest that management acts with Integrity with the mean above the average of 3.29. Nevertheless, the corresponding standard deviation of 1.137 suggests that respondents had a significant variation in responses on management integrity in the execution of their role. However, this could also be construed to imply that respondents might not have clearly understood the dimensions of integrity in this context.

The analysis results indicated that ethical values are upheld in all management decisions as reflected by a mean value slightly above average, 3.11 and standard deviation of 1.034 that showed respondents seemed to have varied in their responses regarding ethical values in all management decisions. The analysis of results in Table 1 reveal a mean of 3.08, implying that the respondents were slightly in agreement in regard to the objectivity and independence of the Audit committees and a standard deviation of 1.124 reveals a significant variation in the opinions which could also relate to not clearly understanding the role of the committee. The results also revealed that the governing council and its committees are independent of management as shown by a mean of 3.66 and the standard deviation of 0.878. Indeed, the study backs up the fact that the major components of effective internal control identified in the general theory are also equally valid in the case of SMEs (Kaplan, 2008; Cunningham, 2004; COSO, 1992; Treba, 2003).

4.2. Perception of SMEs Owners on the Contributions of ICS to the Management of SMEs

The study sought the views of the participants on suggested contributions of internal controls systems. The responses are presented in Table 2.

Contributions of Internal Control Systems	Frequency	%
ICS help keep an organization on course to achieve goals	120	100
ICS help carry out management directives	120	100
ICS reduce surprises	120	100
ICS increase reliability of information	120	100
ICS promote effectiveness and efficiency	112	75
ICS safeguard assets and comply with rules and regulations.	115	90
ICS reduce careless mistakes and avoid risky transactions	118	85
ICS increases staff's efficiency	115	90
ICS teaches responsibility and accountability for money	118	85
ICS is the deterrent to internal fraud and embezzlement	115	90

Table 2: Contributions of ICS to the Management of SMEs

One of the major findings of the interview is that managers of SMEs are aware of the importance of internal control to their operations, although the degree of awareness varies from one SMEs to the other. Based on the data, awareness on the merits of effective internal control system comes as a basis determining all the other activities of the SMEs related to internal control. Indeed, this study found that an efficient system of internal control is typically said to be absent or not strong enough in most of SMEs in general. However, the empirical findings of this research emphasize that SMEs are well aware of the importance of effective internal control and work consciously to bring about such a system in their respective enterprises (Institute of Internal Auditors, 2005; COSO, 2006; Sampson, 1999; Wai, 2008).

4.3. The Relationship between Main Components of Effective Internal Control and SMEs

The variable of the basic element of an effective internal control system was operationalized as: Control Environment, Risk Assessment, Control Activities, Accounting, Information and Communication Systems and Monitoring or Self Assessment as shown in table 3 below.

Components Internal Control Systems	Frequency	%
Control Environment	130	87
Control Activities	90	80
Risk Assessment	123	82
Information and Communication Systems	128	88
Monitoring or Self Assessment	113	85

Table 3 Interrelated Components Internal Control Systems

As shown in table 3, the overall environment of control relies on a proper distinction of levels of authority and responsibility, earmarking of standard codes of conduct that ensure integrity and ethical values among management and employees and mitigation of avoidable risks. Ensuring a proper control environment is identified by the COSO Internal Control Integrated Framework as one attribute of effective internal control (COSO, 1992).

Control activities are made more effective if transactions of the SME are facilitated by a computer system. These activities are also highlighted by the COSO framework as key attributes of effective internal control (COSO, 1992). Therefore, these findings share the concern of the theoretical framework on the importance of managing risks (COSO,

1992; Sampson, 1999). Smooth flow of information and external as well as internal communication is shown in the results to be one mechanism of ensuring effective internal control in the case of SMEs. This logic is also embraced by the COSO Integrated Framework of Internal control (Institute of Internal Auditors, 2005; COSO, 1992).

4.4. SMEs Compliance with the Principles of Effective Internal Control

The respondents were asked to respond to the item on the questionnaire concerning internal control systems used to manage SMEs. Their responses were calculated and presented in the table 4 below.

Compliance with Internal Control Systems	Frequency	%
Awareness on internal control	120	100
Use of computer system	115	100
Levels of authority and responsibilities	110	100
Risk mitigation	118	100
HR Policies and codes of conduct	105	75
Communication	116	90
Evaluations	118	85

Table 4: SMEs Compliance with the Principles of Effective Internal Control

One of the major findings of the interview is that managers of SME are aware of the importance of internal control to their operations although the degree of awareness varies from one SME to the other. When asked if they use computer software to facilitate their daily operations, the managers unanimously stressed how heavily they depended on the application of computer software. Interestingly, when asked if they have an internal auditor, the majority made it a point that they use the computer system to cross-check transactions.

Given the small number of employees in small enterprises, one would assume that division of roles and responsibilities is inexistent. However, what our findings reveals is that SME have their own mechanisms to place check and balance on financial transactions. The small medium sized enterprises are aware of the risks involved in their business activities. Daily reconciliation and other control activities described above have the ultimate goal of mitigating risk. Although the enterprises do not call it a full-fledged human resource policy as such, they insist that they have a general code of conduct that reflects the general orientation of the enterprise and that serves as a control mechanism.

Internal and external communication is generally considered important for the enterprise. Employees also undergo regular evaluations of job performance in most of the cases. One major indicator that ensures proper internal control for SMEs is the well-functioning of the systems designed to effect internal control. The above findings of the research are found to be in line with the COSO Integrated Framework of Internal Control (Aldridge & Colbert, 1994; Applegate & Wills, 1999; Bushman, 2007).

5. Conclusions

In conclusion, it can be said that although the level of awareness differs from one SME to the other, SMEs are conscious of the significance of effective internal control. This perception is evaluated against the five components of an effective internal control system. Thus, these sample SMEs are said to have an internal control system that complies with the principles of effective internal control. Also, there is a significant positive relationship between internal control system (control activities, control environment, risk assessment process, information and communication system, control activities and monitoring & evaluation system) with management and performance of SMEs.

6. Recommendations

Based on the findings, analysis, discussions and conclusions of this study, the following recommendations are made:

- Competence profiling which should be based on what the SMEs expect the internal audit to do and what appropriate number staff would be required to do this job.
- SMEs should manage knowledge/information management system within their set up so as to enable all parties within the organization to freely access and utilize the official information.
- The study recommends that there should be a deliberate attempt to conduct a study which establishes the relationship of SMEs management's commitment based on factors that are external to the SMEs such as behavioral issues of the staff, financial stress of SMEs owners, and information technology.
- The Internal Audit Units should be established within the SMEs organizational structure and the existing ones should be strengthen and well resourced, this would go a long way to help ensure effective control over the internal control systems
- SMEs directors and management should spill over the effects of financial accountability to more people in their SMEs by involving departmental heads and senior management staff in budgeting and procurement process.

7. References

- Aldridge R & Colbert J. (1994). Report on Internal Control, and the Accountant's Response. *Managerial Auditing Journal*, 9, (7), 21-28
- Applegate D. & Wills T. (1999). The Internal Auditor: Struggling to incorporate the COSO recommendations. Website of The Institute of Internal Auditors. www.theiia.org [Retrieved: 2018-04-28]

- iii. Bushman M. (2007). Designing an effective internal control system. Website of Associated Content. www.associatedcontent.com/user/38548/melissa_bushman.html [Retrieved: 2018-05-15]
- iv. CIMA Official Terminology (2005). Chartered Institute of Management Accountants, CIMA Publication.
- v. COSO (Committee of Sponsoring Organizations of the Tread way Commission) (1992). Internal Control Integrated Framework, Executive Summary. COSO website. <http://www.coso.org/publications.htm> [Retrieved: 2018-02-16].
- vi. COSO (Committee of Sponsoring Organizations of the Tread way Commission) (2006). New Guidance for Small Business to Be Released. COSO website. www.coso.org/PR_ICF_Smallerpubliccompanies [Retrieved: 2014-02-16]
- vii. Cunningham, L. A. (2004). The Appeal and Limits of Internal Controls to Fight Fraud, Terrorism, Other Ills.
- viii. Institute of Internal Auditor (2005). "COSO's Theory in to Practice". Tone at the Top. Website of the Institute of Internal Auditor. www.theiia.org [Retrieved: 2014-02-27]
- ix. Kaplan Publishing UK, (2008). Professional Accountant (PA). The Complete Text.
- x. KPMG, Corporate governance in Europe. KPMG Survey 2001/02
- xi. Sampson D. (1999). Understanding Internal Controls: A Reference Guide for Managing University Business Practices. University of California Website. www.ucop.edu/ctlacct/under-ic.pdf [Retrieved: 2014-02-18]
- xii. Treba L. M. (2003). Evaluating internal controls: control self-assessment in government.
- xiii. Wai L.Y. (2008). Importance of Internal Auditing: Small and Medium Enterprises' (SMEs) Perception". Putra Malaysian University website. <http://km/www.upm.edu.my> [Retrieved: 2014-04-25]
- xiv. Waweru, M.G. (2007). Addressing the different Tax Policy and Tax Administrative challenges of Micro, Small and Medium Businesses. A presentation at the International Tax Dialogue Global Conference From 17th -19th October 2007 At Buenos Aires, Argentina.