

Using Internal Controls Systems for Small and Medium Enterprise Sustainability in a Developing Nation

Lisa NQALA and Tichaona Buzy MUSIKAVANHU*

Boston City Campus, South Africa

Internal control systems are an essential component of every organisation, as they are known for their impact on prevention and risk mitigation. However, limited studies examine the nexus between internal control systems and small and medium enterprises (SMEs). Although SMEs play a crucial role in enabling the country's financial stability, SME owners and managers in developing countries are perceived to lack knowledge of internal control systems. This conceptual paper aims to bring a broader understanding of SME leaders and managers on knowledge of implementation of quality internal controls systems towards SMEs' survival and impact on the country's economy. This paper analyses the relevant literature on internal controls' implementation, the knowledge of SME leaders and owners on quality implementation of internal control systems, SMEs' survival and impact on the economy of the country. An existing and persisting perception that internal control systems can only be implemented by large organisations is a major concern. Based on the literature, this study discovered that SMEs could also implement effective and efficient internal control systems and improve their performance. Adequate knowledge by SME leaders and management could improve SMEs' implementation of internal control systems. The literature from the study revealed that improved implementation of internal control systems would subsequently enhance the country's economy.

Keywords: internal controls, SMEs, developing nation, South Africa

JEL Classification: M41

1. Introduction

SME owners and managers lack knowledge of implementing internal control systems effectively. This inevitably results in poor performance, SME failure, and negatively impacts the country's economic growth (Bruwer and Coetzee, 2016; Dubihlela and Nqala, 2017; Jackson and Stent, 2014; Njaramba and Ngugi, 2014). The absence of effective and efficient internal control systems makes managing organisational performance

*Corresponding Author:
Tichaona Buzy Musikavanhu, Boston City Campus, Stellenbosch, South Africa

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difficult (COSO, 2013; Harrer, 2008; Tetteh et al., 2022). Internal control systems prevent and also mitigate the risk that threatens the ability to achieve specific business performance objectives.

SMEs contribute significantly to economic growth and job creation worldwide (Burger, 2016; Olawale and Garwe, 2010; Thulo, 2015). Akugri et al. (2015, p.262) postulated that the SME sector in Africa has the power and influence to transform economies. Moreover, Morongwa (2014, p. 1) highlighted that SMEs are pivotal to the South African economy as they help to eradicate unemployment. Consequently, they also facilitate bridging the inequality gap between the rich and the poor (Abor and Quartey, 2010; Hatten, 2014; World Bank, 2013, p. 1). Developing countries such as South Africa still face a high unemployment rate, and SMEs promise to create much-needed jobs for semi-skilled and unskilled labour (Burger, 2016; Olawale and Garwe, 2010; National Small Business Chamber, 2016; Thulo, 2015).

Several studies have been conducted to understand why SMEs fail despite receiving some support from government and non-governmental organisations. SME leaders are perceived to lack managerial and operational skills (Doveston, 2011; Olawale and Garwe, 2010; Thulo, 2015), such as internal control systems, leading to a high failure rate in developing countries such as South Africa. Furthermore, Jiang and Li (2010, p. 214) suggested that many SMEs fail because they suffer from internal operational problems, especially in finance and in implementing effective internal controls to mitigate risk. The impact of ineffective internal control systems within the organisation is significant as it eventually led to the closing down of the business. Studies suggest that over the past decades, several enterprises have been shutting down due to fraud, misuse of business assets or resources, and manipulation of business financial statements (Ahmed and Muhammed, 2018; Perry, 2016). Kakuru (2015, p. 1) suggests that SMEs must implement adequate and effective internal control systems as they are crucial for detecting and preventing risks. In concurrence, Samadi (2016, p. 1) suggests that adequate internal control systems are necessary for large businesses and even SMEs with limited resources.

When SMEs effectively implement internal control systems, they will be able to achieve three goals: (1) Compliance with the laws and regulations, (2) Enabling the safeguarding of assets and (3) Enhancing the completeness and accuracy of financial records (Bruwer and Coetzee, 2016; Dubihlela and Nqala, 2017; COSO, 2013). SMEs with ineffective internal control systems could suffer from irregularities such as fraud, theft, the misuse of assets and unreliable financial information reporting leading to premature shutdown of the business (Akani and MrOladutire, 2013; Kakuru, 2015; Samadi, 2016). Evidently, internal control systems directly and indirectly influence SMEs' sustainability, which inevitably impacts the country's economy (Alfartoosi et al., 2021; Bruwer and Coetzee, 2016; Dubihlela and Nqala, 2017; Jackson and Stent, 2014; Njaramba and Ngugi, 2014; Tetteh et al., 2022). With the above background in mind, this study brings a broader and more holistic understanding of the effect of adequate knowledge of the implementation of internal control systems towards SMEs' sustainability and their positive impact on the South African economy.

2. Literature Review

The existing perception of previous researchers is that SMEs do not implement internal controls to protect their businesses and, thereby, dismiss the challenges that SMEs experience. The implication is that the ongoing failure of SMEs could discourage new SME owners and investors. Bruwer, Smit and Siwangaza (2018, p. 7) suggest that small to medium businesses must design quality internal control systems and management skills for the South African economy. Improving internal controls and managerial skills for SMEs and SME owners and managers leads to SMEs' sustainability, which positively impacts South Africa's economy (Dubihlela and Nqala, 2017). The decrease in SMEs' failure rate in South Africa would encourage the new owners of SMEs and consequently motivate investors to invest in them.

Some studies have pointed out that this issue is not limited to South Africa but has affected the whole of Africa. In developing nations, SMEs struggle to survive due to the smallness of local markets, poor infrastructure, complex socioeconomic conditions and inadequate financial systems (Hatten, 2014; Olawale and Garwe, 2010; Thulo, 2015). Additionally, mitigating and preventing the problem at hand will improve the African economy. The knowledge of internal control systems is crucial to SME businesses. A better "understanding of internal control systems improves SMEs' implementation of internal control systems" (Bruwer and Coetzee, 2016; Njaramba and Ngugi, 2014; Perry, 2016).

The definition of internal control systems makes it clear that it is the management or leaders' responsibility to "design and implement effective internal control systems". Several factors are affecting the

implementation of internal control systems within SMEs. Whittington and Panny (2012, p. 278–279) mention that the expansive segregation of duties in larger businesses achieves effective internal controls. In contrast, in small companies, it is a concern because of fewer employees, resulting in the implementation of internal controls likely becoming weak or not implemented at all. As mentioned by Cika (2018, p. 53), “designing effective internal control systems is determined by some of the following factors: the size of the organisation, the level of the accounting department, cost, and resulting benefits”.

Notably, Louwers et al. (2006, p. 152) posited that SMEs should design and implement internal controls but not in the same way as larger entities. The study concludes that the framework for implementing internal control systems in SMEs will never be the same as in larger businesses due to different factors and limitations. Akugri et al. (2010, p. 262) recommend that occasional training for SME owners and managers be implemented for basic record-keeping and management skills. Small ventures are unlikely to have documented codes of conduct, external directors or formal policy manuals. Moreover, they are synonymous with a lack of adequate personnel to provide adequate segregation of duties for internal auditors. They, nevertheless, can reduce the mentioned conditions by promoting a culture that fosters integrity, ethical values, and competence (Boynton and Johnson, 2006, p. 416). SMEs can also integrate internal control systems within their operations, obliging every employee to safeguard the company’s resources (Hayes et al. 2005, p. 232).

2.1. Knowledge of Internal Control Systems

For management to be able to design and implement effective internal control systems, they must have a better understanding of different types of internal control systems and their purpose. Furthermore, Harrer (2008, pp. 65–66) mentions that the Committee of Sponsoring Organisation of the Treadway Commission (COSO) “explains internal controls to consist of five components related to all entities: control environment, risk assessment, control activities, information and communication, and monitoring”. Larger and small businesses may implement internal controls differently, but they both must have effective internal controls. Below (Table 1) is a list of internal control systems and their purpose.

Table 1. Types of internal controls systems (own construction)

Types of internal controls systems	Explanation
Key control or primary control	They are designed to mitigate the key risks related to the business objectives (Reding et al., 2016).
Secondary controls	They are designed either to (a) mitigate primary risks and (b) partially mitigate the level of risks when a key control does not work effectively (Reding et al., 2016).
Compensating controls	They are designed to complete or enhance the key control and exist where ineffective internal control could be compensated for by another control (Cascarino and Van Esch, 2007, p. 55).
Complementary controls	They are controls that cannot work effectively independently; they must be combined with one or more other controls to operate effectively (Reding et al., 2016).
Directive controls	They are designed to encourage a desirable event to occur (Njeri, 2014, p. 13; Richard, 2009, p. 9).
Preventive controls	They are designed to deter and prevent undesirable events and potential risks before they happen (Njeri, 2014, p. 13).
Corrective controls	They are designed to inform or address every problem the system has encountered and involve follow-up and correction measures by the management (Lemi, 2015, p. 14; Njeri, 2014, p. 13).
Entity level controls	They are defined by the Securities and Exchange Commission (2007, p. 54) as “aspects of systems of internal control that have a pervasive effect on the entity's systems of internal controls.”
Information system controls	Reding et al. (2016) outline the two types of information systems controls: <i>General computing controls</i> are designed to ensure the continuity and efficiency of operations, and it is considered entity-level control. <i>Application controls</i> are computational steps within the application software. They also include manual procedures to control the processing of several transactions.

A better understanding of these types of internal control systems shown in Table 1 above is crucial. When SME owners and managers brainstorm the design and execution of internal control systems, these systems will help them accomplish their business goals, comply with rules and regulations, and defend the company's assets and reliable financial information.

From an empirical point of view, fewer studies have investigated the effect of adequate knowledge on the implementation of quality internal control systems towards SMEs' survival and impact on the South African economy. A study was conducted by Ahmed and Muhammed (2018) in Uganda on the role of internal control systems in the financial performance of fuel companies. The study examined internal control systems' role in the financial performance of fuel companies in Uganda. The author also pointed out that effective internal control systems help to detect and deter fraud and provide reliable assurance that the business's goals will be realized. Furthermore, Akani and MrOladutire (2013, p. 7) posited that businesses suffer so much that they lose their assets and even shut down due to irregularities related to weak internal controls. Effective internal controls contribute to the efficiency of the operation by mitigating and preventing risks such as the misuse of assets, wastage, and the preparation of unreliable financial reporting (Alfartoosi et al., 2021; Dubihlela and Nqala, 2017; Jackson and Stent, 2014; Njeri, 2015, p. 1).

2.2. Implementation of Internal Control Systems by the SMEs

The failure to implement quality internal control systems could lead to the failure of SMEs to achieve their business objectives and survive. When SME owners and managers prioritise the implementation of key controls, the business will not be susceptible to high risk, which is a cause of most SME failures. However, most SMEs face the challenge of inadequate employees to segregate duties. Reding (2016) cites that the proposed solution is to use compensation controls. These are designed to complete or enhance controls when they are not working effectively to mitigate and prevent risks on an acceptable level (i.e., close supervision when adequate segregation of duties cannot be achieved). This is to say that when SME owners and managers implement compensation controls, they mitigate the challenge of segregation of duties. The current perception of previous researchers is that SMEs do not implement internal controls to protect their businesses and, thereby, inadvertently dismiss the challenges SMEs experience. This is despite the fact that previous researchers have made it clear that SMEs fail and struggle to survive due to a lack of management skills for implementing proper internal control systems. This study contends that if SMEs adequately implement internal controls, this would significantly influence their sustainability and ability to prevent and mitigate risks. Inevitably, SMEs' sustainability and growth positively impact South Africa's economy.

3. Conclusion

This paper presented the much-needed knowledge for SME owners and managers to better understand internal controls system implementation and their impact on the survival of small and medium entities to improve the country's economy. This knowledge of internal control systems will be useful to SME owners and managers, and government policymakers, to enhance their decision-making skills. This study referred to the nature of SMEs, which often challenges internal control implementations. These include fewer or semi-skilled employees and the complicatedness of internal control systems, which could hinder the successful implementation of new systems. However, measures have been suggested to circumvent these challenges.

As an emphasis, SME owners and managers must be aware of the different types of internal control systems, why they are implemented and how to implement them. They should ensure that a controlled environment is their priority for effective business operation. Adapted and effective internal control systems for SMEs are not optional but a must-have. SME owners and managers who lack an understanding of internal control systems and how to implement them must seek the necessary training before placing more expectations on employees. Moreover, the COSO provides a broader understanding and guidance on internal control systems and enterprise risk management. SME owners and managers can use the COSO framework documents to better understand internal control systems' components and how to implement them effectively. The COSO framework documents are available online. These can be a useful go-to guide for SME owners and managers in all matters of internal control systems to better position their businesses in a sustainable pathway.

This study mainly focuses on SMEs' use of internal control systems from a developing nation's perspective. Future studies can empirically analyse how specific SMEs are implementing internal control

systems and how effective they are in ensuring specific SMEs' sustainability. A comparative study can also be conducted between developing and developed nations to understand the similarities in how internal control systems are being implemented.

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