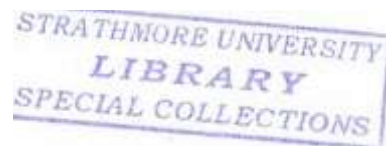


AN EVALUATION OF INTERNAL CONTROLS:
THE CASE OF NAIROBI SMALL BUSINESSES

By

WILFRED KAKUCHA



2009



Declaration

This research thesis is my own original work and has not been submitted in any other university.

Signed.

Date

Wilfred N. Kakucha

This research thesis has been submitted for examination with my approval as the university supervisor

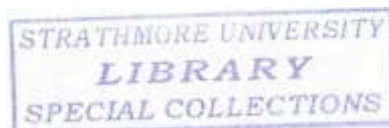
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Date

James Boyd McFie

Director of Academics and Research

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Dedication

To Mum and Dad

Acknowledgement

I would wish to acknowledge with sincerity the support of my supervisor, Dr. James Boyd Mcfie for his tireless effort in guiding me throughout the duration of the research thesis.

Secondly, my sincere gratitude goes to David Wango'mbe, DR. Ruth Kiraka, Professor Naituli Gitile and the entire Faculty of commerce board members for their constructive and helpful suggestions.

Finally, my gratitude goes to all the small scale business owners who gave me access to their business premises and enabled me to carry out this study.

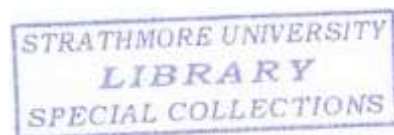


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Abstract

This study evaluated the level of effectiveness of internal controls in small businesses operating in Nairobi. Secondly, this study examined the relationship between the age of an enterprise and effectiveness of its system of internal control. Thirdly, this study explored the relationship between the amount of resources held by an enterprise and its effectiveness of its system of internal control. Fourthly, this study investigated the nature of the relationship between internal control and financial performance. The study was quantitative and was carried on from September 2007 to June 2009. Using a sample of 30 small businesses as listed in the National Social Security Fund (NSSF) Register of Kenya, 2008, the study sought to meet the above mentioned objectives. Data was collected from the managers of small businesses using interviews and examination of documents pertaining to internal control. The response rate was 80%. Data was then analyzed using descriptive statistics and regression analysis. The study found that there are deficiencies in the systems of internal controls, with the degree of deficiencies varying from enterprise to another. The components of internal control that were missing in most businesses surveyed were: firstly, risk analysis; and secondly lack of proper flow of information. In addition, the study established that 56.7% of the sample population lacked awareness of what constituted an effective system of internal control. The study also found that there is significant statistical evidence to support the negative relationship between the age of an enterprise and the effectiveness of its system of internal control. In addition, the study established that there is a strong negative correlation between the resources held by an enterprise and its internal control weaknesses. Finally, the study found that there is a weak negative relationship between internal control weaknesses and financial performance. There is need to enlighten operators of small businesses of what constitute an efficient and effective system of internal control through seminars and forums. To cut down on the cost of maintaining fully fledged internal audit and human resources departments, the small businesses should outsource this to specialist professional firms who will aid them on a timely basis. The researcher suggests that there is need to replicate the study in medium and large enterprises. Finally, there is need to establish the nature of frauds occurring in small businesses.

CHAPTER ONE

INTRODUCTION

1.1 Background of the study

According to a World Bank report, small businesses are defined as enterprises that employ between eleven and fifty people at any given time (World Bank, 2003).

The Committee of Sponsoring Organizations of The Treadway Commission (1992) defines internal control as "a process effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories: effectiveness and efficiency of operations; reliability of financial reporting; compliance with applicable laws and regulations. "

Kenya made progress in closing the gap between national accounting and auditing practices and international standards, notably by adopting the International Accounting Standards (IASs) and the International Standards on Auditing (ISAS) as a national requirement. However, compliance with the requirements of IASs and ISAS is partial, due to the enforcement mechanism that continue to evolve and inadequate resources. Although the country has taken some measures to improve its economic governance, economic growth and various social indicators continue to decline. This is partly an indication of how deeply entrenched many problems are, including the area of financial accountability in both private and public sectors. weaknesses in corporate governance practices, inadequate systems of internal control, lack of pressure from users of financial statements for high quality information, and the general absence of transparency in the corporate sector. The fact that a number of banks failed in the late 1990s and the audited financial statements did not provide early warnings signals about those failures, raised concerns among the general public about the quality of accounting and auditing in the country (World Bank, 2002).

According to Alvin et al. (2003), in a survey carried out by KPMG on fraud prevention and detection mechanisms on 5,000 firms in the US, it was found that the most effective fraud detection mechanism was detection through notification by employees. The second most effective fraud detection mechanism was detection by the use of internal control. Similarly, the American Institute of Certified Public Accountants (1987) argues that internal controls are often thought of as the primary defense against fraud. In addition, internal controls aid organizations in the following objectives: one, to safeguard the assets of the firm; two, to ensure the accuracy and reliability of accounting records and information; three, to promote efficiency and effectiveness in the firm's operations.

According to the National Commission on Fraudulent Financial Reporting (1987), for an internal control system to be considered effective, it should encompass preventive, detective, and corrective controls: good internal controls make it difficult to conceal fraudulent activities in the organization.

Controls within an organization are meant to encourage efficient and effective use of its resources, including personnel, to optimize the company's goals.

Another aspect of efficiency and effectiveness is accurate information for internal decision making. A variety of types of information is used for making critical business decisions. In addition, effective and efficient internal controls help in safeguarding assets and records of the company against theft, misuse or damage (Alvin et al. 2003).

Bronson et al (2006) argue that not only do internal controls aid to combat fraud but they also impact on the firm's financial performance. As a result, weak internal controls are positively related to poor financial performance and effective and efficient internal controls are positively related to superior financial performance. These authors concluded that holding other factors constant, evidence suggests that the system of internal control in place significantly impacts on the financial performance of a business.

Although large businesses are more likely to experience economic crime, fraud has been found to be relatively more costly to small businesses. The damage caused by fraud costs

the business heavily in terms of collateral damage, reputation damage and a decline in the credit rating of the business (Thomas and Gibson, 2003; Pricewaterhousef.oopers, 2003).

According to a study carried out by the ACFE (2004) it was concluded that total losses emanating from fraud are 100 times greater in small firms than in large firms. Despite an alarming increase in incidents of fraudulent activities, many small businesses have not taken proactive measures to better their businesses fraud prevention and detection mechanisms. In addition, Thomas and Gibson (2003) argue that internal controls have not been accorded proper attention in small businesses.

Since investigating and detecting fraud are challenging endeavors, many organizations are now opting for a more viable strategy of fighting fraud. This strategy involves investing in fraud prevention mechanisms (Wells, 2004). As the most basic preventive measure against fraud, Loebbeck and Willingham (1989) developed a conceptual model to evaluate the possibility of occurrence of fraud in an organization. The researchers concluded that assessment of an organization's internal controls is significant in evaluating the possibility of the occurrence of fraud.

Similarly, Moyes and Baker (2003) conducted a study on fraud: auditing techniques. They concluded that the most effective fraud audit techniques are those yielding evidence about the existence and the strengths of internal controls. Buijink et al. (1996) states that internal control systems should be seen as an area of priority by business managers and business owners. In addition, there is a need for more research approaches on fraud prevention whose findings will add to the current body of knowledge and equip business managers with better fraud prevention techniques.

According to Haskins (1987), an organization's size has a direct impact on the kind of internal controls kept. For example, due to fewer numbers of employees in small businesses, it is difficult to establish adequate separation of duties. It would also be unreasonable to expect small businesses to have internal auditors. However, when various components of the internal control systems are analyzed, it becomes evident that

most of the internal control components are applicable in both small and large enterprises. Haskins recommends that internal controls in small businesses can be strengthened if the owner carries out the following duties: signing of cheques only after carefully reviewing the supporting documents; reconciliation of the bank statements; approving credit; and writing off bad debts only after proof has been given of real efforts having been made to collect the debts.

In addition, Ge and McVay (2005), Kinney et al. (1989), Geiger and Taylor (2003), and Krishnan (2005) argue that the status of internal controls in place is not only affected by the size of the enterprise but also by the age of the enterprise, and the financial resources controlled by the enterprise. Ge and McVay (2005) argue there is a positive correlation between older firms and effective internal controls. The older a firm is, the more experience it acquires and the better its system of internal control. Kinney et al. (1989) argue that the more resources a firm has, the more effective and efficient is its system of internal control. This is because of the fact that availability of resources warrant the organization to hire the services of auditors, consultants and skilled personnel who can improve the internal controls system in place.

1.2 Statement of the problem

According to a US study by the Association of Certified Fraud Examiners (ACFE-2004), internal controls seem to be given little attention by operators of small businesses. This failure to design and implement effective internal controls has largely been attributed to limited resources that often make small businesses overlook the benefits of internal controls. In the ACFE study of businesses in the US which had reported cases of fraud, 48% of frauds occurred in small businesses and 93% of all frauds were related to asset

misappropriation.

Given that small enterprises in the US and in Kenya operate in different business environments, and that literature review does not indicate the status of internal controls in small businesses in Kenya, it will be imperative to find out what is the level of efficiency

and effectiveness of the systems of internal control of small businesses operating in Kenya.

In addition, the studies conducted in the US have argued that the age of an enterprise, availability of resources in terms of employees with accounting knowledge, and financial performance are key variables which influence the efficiency and effectiveness of a system of internal control. It will be important to establish whether these variables can influence the efficiency and effectiveness of a system of internal control in the Kenyan context. This study will explore whether this relationship exist and the nature of this relationship

Finally, since fraud has been cited as a major problem of small businesses in the US, given the different business environment in Kenya and the US, It-is imperative to establish whether fraud is a problem facing small businesses operating in Kenya, and if so how recurrent is this problem.

1.3 Objectives of the study The

objectives of this study are:

- (1) To examine the level of efficiency and effectiveness of the systems of internal control designed and maintained in small businesses.
- (2) To examine whether there is a relationship between the age of an enterprise and the effectiveness of its system of internal control.
- (3) To examine whether there is a relationship between the resources held by an enterprise and the effectiveness and efficiency of its system of internal control.
- (4) To examine whether financial performance influence the efficiency and effectiveness of an enterprise system of internal control.

1.4 Research questions

The research questions to be addressed by this study are:

- (1) What is the level of efficiency and effectiveness of the systems of internal control maintained by small businesses?

- (2) What is the nature of the relationship between the age of an enterprise and the effectiveness and efficiency of its system of internal control?
- (3) What is the nature of the relationship between the amount of resources held by an enterprise and the effectiveness and efficiency of its system of internal control?
- (4) To what extent does financial performance influence an enterprise's system of internal control?

1.5 Scope of the study

This study will be limited to small businesses operating within Nairobi. The target small businesses will be screened to ensure that they fit within the World Bank's definition of a small business. The sample population will be based on the list of small businesses in the National Social Security Fund (NSSF) register.

1.6 Justification of the study

The researcher has chosen to study small businesses because research carried out by the World Bank emphasizes the importance of small businesses in developing nations. This report by the World Bank states that if small businesses can be nurtured to ensure their transition to medium sized enterprises, then great gains can be realized in the form of an increment in gross domestic product, employment creation and poverty reduction (World Bank, 2003).

The researcher seeks to contribute to nurturing the general well being of small businesses, by evaluating one aspect which contributes to efficiency and effectiveness of their operations, avoiding loss through fraud and good financial performance. As a result of this study, the researcher will be able to evaluate internal controls in small businesses and make recommendations on how material weaknesses in internal controls can be addressed.

In addition, this study will be of benefit to the academic fraternity by contributing to the current body of knowledge on internal controls in small businesses; in developing nations.

Finally, Micro finance institutions and other lenders of money to small businesses will be assisted by this study: They will be able to replicate the study to establish the effectiveness of the system of internal control in small businesses to which they intend to lend, as a further indicator of whether they will obtain repayment of their loans.



CHAPTER TWO

LITERATURE REVIEW

2.1 Evolution of internal controls

Donald (2006) states that the internal control story goes back many decades beyond the Sarbanes-Oxley Act (SOX). Donald narrates that earlier, internal control requirements were incoherent. This is because the internal control requirements were issued without specifications as to whose benefit those controls existed, and to what end. As a result, internal controls were only adopted to comply with the legal framework. Later, attention started moving from compliance to the benefits of keeping effective internal controls. Focus moved from state corporate law to federal law after the enactment of the Foreign Corrupt Practice Act of 1997 (FCPA) Donald argue that this act added to the Securities and Exchange Act a specific requirement that public companies both maintain accurate books of accounts and implement a reasonable system of internal controls.

The Securities and Exchange Commission (1976) main concern in the 1970s was about adequacy of internal controls and corporate accountability. This concern was as a consequence of increased accounting fraud scandals which elicited questions on transparency and accountability of corporate managers over assets, especially as it related to foreign and domestic bribery and illegal political campaign contributions. With more misbehavior publicized, congress responded with the FCP A. In 1979, with more accounting fraud cases coming into the public limelight, the SEC responded with a proposal which required that management evaluate and report on its internal controls. However, this proposal was later withdrawn.

Donald (2006) states that, "in the late 1990s the Federal Organization Sentencing Guidelines were developed to make clear that corporations with a reasonable compliance system would get some credit at the sentencing phase even though they were found by

impination to have violated federal law, making some affirmative compliance system a defacto requirement for companies with reason to fear criminal prosecution."

Pathak (2005) argues that this piece of legislation set in motion discussions about the scope, depth and context of appropriate and effective internal controls.

Caremark (2001) states that the boards of directors were not entrusted with the responsibility of monitoring internal controls. However, boards of directors were required to respond to signs of misrepresentations of true and fare view of the financial positions of their companies. This came in the wake of increasing cases of financial misreporting especially among banking institutions.

According to Donald (2006), the Securities and Exchange Commission (SEC) continued to express concerns and proposed further evaluation in order to upgrade the quality of financial statements. In the mid 1980s, an aggressive SEC enforcement program focusing on management integrity ensued, and chaired by newly departed SEC commissioner, which made a series of recommendations to address problems; in the internal control environment. In 1988 the SEC introduced again the requirement on management to evaluate and report on its internal controls. However, once again this proposal was not implemented. Instead, The Committee of Sponsoring Organizations of the Treadway Commission (COSO) committed to develop a private sector framework that would give more substance to what good internal controls should be .. Its report, *Internal Controls:*

An Integrated Framework, was released in 1992, and now plays a significant role under the Sarbanes-Oxley Act.

Caremark (2001) adds that the Sarbanes-Oxley Act imposes internal control obligations requiring the management to certify the accuracy of disclosures. In addition, company managers must also affirm that they are responsible for internal controls, they have designed such controls to ensure that material information is brought to their attention, they have evaluated its effec.iveness in the last 90 days, they have presented their concl.isions about its effectiveness, and they have discussed in the report any changes in internal controls during the period under review.

Donald (2006) argues that evaluating internal controls of different organizations' structures required a benchmark with which to compare the effectiveness of a particular organization's internal controls be available; this benchmark has since then been proposed to be COSO's integrated framework.

Albridge and Colbert (2004) state that to complement COSO's integrated framework, Auditing Standard No.2 (AS-2) was promulgated by the Sarbanes-Oxley to regulate the public company audit process. This audit standard set a de facto standard requiring the management to evaluate both the breadth and depth of internal controls. According to Albridge and Colbert, AS-2 recommends that internal controls must provide reasonable assurance that there are no material weaknesses that could lead to material misstatements in the financial statements. AS-2 calls for both preventive and detective controls to counter the risk of material misstatements.

2.2 The Kenyan context

In 1998, the council of the Institute of Certified Public Accountants of Kenya (ICP AK) adopted international standards for financial reporting in Kenya, which thereby became Kenyan standards. All financial statements covering periods beginning January 1,1999, were required to adhere with International Accounting Standards (IASs) and financial statements prepared for the periods ending on and after December 31,1999, must be audited in accordance with international standards on auditing (ISAs).

IASs are Applicable for enterprises of all sizes and types, to the extent that they apply to the specific circumstances of the reporting entity.

Although adoption of IASs and ISAs was an important step in upgrading the financial reporting practices of Kenyan enterprises, there continue to be gaps in compliance with those standards. One problem is that the standards themselves need to be better disseminated: students, trainee accountants, practicing accountants, and auditors must have easy and affordable access to the latest versions. However, it is expensive for Kenya to purchase annual volumes of those standards .In addition, many practitioners believe that the quality of accounting and auditing practice would improve significantly if

ICPAK were to issue manuals on the appropriate application of the standards (World Bank, 2002).

Inadequate quality control arrangements affect the quality of audit work.

Except in the large firms, practitioners generally lack adequate resources to implement proper quality controls, and even large firms with established quality control arrangements may not be in full compliance with the ISAs in this regard.

Similarly, while some audit firms have established procedures for compliance with ISA- 400 on risk assessment and : nternal control, the general business environment in the country restricts proper implementation of the standard. Most businesses have weak internal control systems, and are unwilling to pay adequate fees for the application of rigorous and time consuming audit procedures. Thus auditors are often unable to consider the assed level of inherent and control risks in carrying out substantive procedures required to reduce audit risk to an acceptable level.

In addition, many auditors lack adequate knowledge of information technology to asses the risks of highly computerized clients. (World Bank, 2002).

Improvements are needed in the Kenyan Legal framework governing accounting and financial reporting, the professional education and training arrangements, the professional body, and the enforcement mechanism. Stakeholders in the country believe that successful completion of appropriate capacity-building initiatives, through implementation of an action plan, would help develop accounting and auditing practices and bring about improvements in compliance with the international standards.

In addition, professionals wor .ing in small accounting firms find it difficult to keep up to date with new developments in accounting and auditing. These practitioners state that, because of the downturn in the economy, they are constantly struggling to earn to stay afloat, and they cannot afford ;o spend money and time on training programs. The small and i nedium-sized practitioners in Kenya are also handicapped by their lack of access to appropriate literature on the application of established accounting and auditing standards (ICP AK, 2007).

2.3 Components of Internal Controls

Empirical research conducted by various authors agrees on the following to be the components of internal controls: Control environment, risk assessment, control activities, communication and monitoring (Michael, 2004; Steven, 2000; Alvin, 2003, Kenneth, 2005; Raquel, 2005).

However, according to Zabihollah (1995), majority of the researches on internal controls refer to the Committee of Sponsoring Organizations of the Treadway Commission (COSO) report on internal control integrated framework.

This report emphasizes the importance of internal control in achieving an entity's objective and providing the impetus for entities to refocus attention on their systems of internal control in an attempt to ensure reliable financial reporting process. Thus, the COSO report is the benchmark for evaluating effective and efficient internal controls .

. Figure 2.1: Internal control components



According to the COSO report, the interrelated components of internal control must be present and functioning properly in order to have an effective internal control system. The interrelated components of internal controls include:

One, Control environment, this is the foundation of the other components of internal control. The control environment supports the other components of internal controls. The control environment consists of actions, policies and procedures that reflect the overall attitude of the top management towards internal controls. Proper internal control should be reinforced by the management by modeling the way the organization should be run based on the underlying policies and

procedures. The Management should set a proper example through their day to day actions that will enable the junior staff to emulate them.

According to the COSO report, the control environment is supported by:

Integrated ethical values which include management actions and policies to reduce or remove incentives and temptations that might lead to illegal, dishonest, or unethical acts. Integrity and ethical values can be reinforced through communication of the entity's value and employees through policies, and a statement of code of conduct which can be reinforced during hiring of new employees, seminars, forums, etc.

There should be commitment to competence through hiring of employees with appropriate skills and experience to be able to carry out their duties successfully,

There should be an independent board of directors to oversee the actions of management. This board should be free of interference from both internal and external sources. The board's audit committee should be a watchdog to ensure proper internal controls are kept and updated from time to time.

For an efficient internal control environment, there should be proper assignment of authority and responsibilities. This might include assigning particular jobs to a particular

employee so that he/she can be held accountable in case of misappropriation or misuse of assets.

The human resources' department is also considered a critical component of the internal control environment. The human resources' department should ensure that it screens its employees to ensure the organization recruits and retains trustworthy and honest employees.

The method in which personnel are hired, evaluated, trained, and promoted becomes an important aspect of the internal control system. Proper screening of employees during interviews will ensure that organizations hire people of good morals and values and who are likely to easily adapt to the underlying organizational values. For example; proper evaluation and compensation of employees brings about fairness in the organization because none of the employees will feel underappreciated. Hence they will not want to engage in activities like perpetrating fraud which will make them even with other employees.

Two, risk assessment, according to the COSO report (1992), risk assessment entails proactive investigations and identification of both internal and external risks facing the organization. Risk assessment enables management to understand the risks the organization is exposed to and therefore react in a timely manner.

All business organizations regardless of their size, structure, or nature of the industry in which they operate, face a diversity of risks. This is because the business environment is dynamic and constantly prone to changes.

Management of organizations should proactively conduct risk analyses so that they can spot likely risks and devise measures to mitigate them.

Identifying and analyzing risks are therefore important elements of the internal control system. Failure to forecast risks and suggest possible remedies weakens an organization's internal control system.

Three, control activities, the COSO report (1992) defines control activities as "policies and procedures that help to ensure that necessary action are taken to address risks facing the organization." This report identifies three categories of control activities: operating controls, financial information controls, and compliance controls. Operating control activities include: segregation of duties, proper authorization of transactions, adequate documents and records, physical control over assets and independent checks on performance.

Financial information control activities help to ensure a reliable financial reporting process and safeguarding the entity's assets.

Compliance control activities are designed to ensure that the organization complies with applicable laws and regulations.

According to Alvin et al. (2003) there should be a proper separation of duties in the organization. This may include separation of custody of assets from accounting. Alvin et al. argues that a person who has custody of assets should not be permitted to account for them. This will help to counter the risk of him taking the assets and falsifying the financial statements to relieve himself of the risk of being caught.

For example, if the cashier receives cash and is responsible for data entry for receipts and sales, it is possible for the cashier to take the cash and fail to record sales.

There should be separation of the authorization of transactions from the custody of related assets. A person who authorizes transaction should be separated from having control over the assets. The same person should not authorize the payment of a vendor invoice and also sign the cheque to authorize payment of the bill.

Power (1997) states that transactions should be properly authorized. Authorization can either be general or specific. Under general authorization, it is important that management establishes policies and procedures that the organization will adhere to. This policies and procedures may include credit limit, and fixed reorder points for making acquisitions.



Specific authorization can only be applied in individual identified transactions. Approvals are made on a case by case basis; comparison of quantities of inventories in hand to a master file or reorder point level should be carried out from time to time.

McIvullen (1996) argues that there should also be a separation of information technology duties from the user department to prevent potential overlaps of duties. McMullen argues that it is imperative that companies separate major information technologies related functions from key user department functions. The responsibility for designing accounting software programs should be in the information technology department while the duties to update information in the computer system should be within the accounting system.

Kenneth (2005) states that all transactions carried out by the organization should be properly recorded and documented. For proper controls to be designed that will allow for an efficient monitoring of an audit trail there should be adequate records and documentation. As a result, both documents of original entry and records upon which transactions are entered are important. Inadequacy in maintenance of those documents brings about inefficient control.

These documents should be pre-numbered consecutively to facilitate control of missing documents and enable faster tracking of these documents.

Kenneth argue that measures should be taken to ensure proper control of assets. The management should ensure that assets are not left unprotected as this makes them vulnerable to theft or physical damage.

Alvin et al. (2003) argue that it is important to ensure that information is only accessible to those individuals who deserve to access it. For this reason, passwords should be assigned to individual users and this password should be changed from time to time. Inventories should be kept in storerooms and a store clerk assigned to protect the inventories from theft. Where the store is under the use of competent personnel this further reduces the chances that inventory could suffer obsolescence or expire without being noticed.

Four, information and communication, According to the COSO report (1992), this component of internal control emphasizes on proper flow of information in the organization. Emphasis is made that communication should flow in all directions in an organization.

Personnel who are affected by the internal control system should be educated on the various components of the internal control system, how the internal control system works and their roles to ensure that the organization maintains an 'effective internal control system.

Five, monitoring, according to the COSO report (1992), this component of internal control requires that the internal control systems are monitored both on a periodic and on an ongoing basis. This component of internal control oversees the other four controls mentioned. Internal controls are dynamic and change from time to time. Without independent checks the personnel may ignore the control in place, override controls or intentionally fail to abide by the laid down procedures. Internal controls should be monitored by management to ensure that they are operating as intended and that they are modified when need arises. The duty of establishing criteria against which to monitor and evaluate the four mentioned components of internal controls is bestowed with the management. Deficiencies noted should be reported to the individual responsible for the function so that corrective measures can be taken.

2.4 Criteria for evaluating internal controls

The COSO report presents a framework which enables a common understanding of internal control among the relevant parties. This report provides criteria to assist management in designing, implementing and improving the internal controls in their entities. However, the focus of the COSO report is on control over financial reporting. The integrated framework of internal controls, as described by the COSO report, consists of five interrelated components. When evaluating internal controls, the accountant should ensure that each of the internal control components is working effectively. When writing

a report on internal controls the report should discuss each of the five internal control components.

The COSO report further provides two alternative reporting time frames. Period of time reporting and point in time reporting.

The time frame selected is important for two reasons.

First, the timeframe affects the assessment process. This is because a report covering a period of time involves more extensive evaluation and testing of controls. Second, the time frame affects the disclosure of deficiencies and the conclusion management reaches about effectiveness of controls. The COSO report recommends point in time reporting rather than period reporting (COSO, 1992).

According to the National Commission on Fraudulent Financial Reporting (1987), the management should report on the effectiveness of internal controls. In evaluating the effectiveness of internal controls in a particular entity, an extensive analysis of the five components of internal controls should be conducted. Any limitations in the internal control system arising from errors, collusion, and management override should be discussed. The report further states that "A discussion of inherent limitations helps prevent readers of the report from believing that an effective control system can prevent or detect all misstatements."

2.5 Material weaknesses

The American Institute of Certified Public Accountants (1988) defines a material weakness as "a condition in which the design or operation of the specific internal control structure elements do not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material to the financial statement being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned function."

According to the American Institute of Certified Public Accountants (1993), there are three types of tests the accountant may use to gather evidence regarding the effectiveness of internal controls:

The first test is gaining an understanding of internal control by the use of an internal control questionnaire;

The second test is gaining an understanding of internal control by observation of the day-to-day activities of the organization. (For example, the accountant may observe the client accepting cheques, and verifying identification.);

The third and final test is gaining an understanding of the internal control system through inspection of the client's documentation system. Documentation might be in the form of policies and procedures, manuals, flowcharts or narratives. Inspection of the organization's documents might be particularly useful when evaluating the risk assessment component of the client's system. This is due to the fact that anything pertaining to risk analysis is usually documented.

2.6 Relationship between internal control and financial performance

The ability to establish proper internal controls might vary with a firm's financial performance. Poorly performing firms simply might not be able to adequately invest in proper controls (Krishnan 2005). Good internal controls require both financial resources and company time, and may not be a priority for firms that are concerned about simply staying in business. In addition, poorly performing firms may be undertaking actions, such as downsizing, which could create holes in their existing internal controls. Therefore, disclosure of material weaknesses is likely to be negatively associated with profitability.

Similarly, Ge and McVay (2005) provide empirical evidence that disclosing material weaknesses in the internal control system is negatively correlated with firm profitability. On the other hand, when there are no material weaknesses in a firm's internal control system, the firm is likely to report a superior financial performance. In addition, according to Alvin et al. (2003), internal controls bring about efficiency and effectiveness of operations. As a result, this impacts positively on a firm's financial

performance. Controls within the organization are meant to encourage efficient and effective use of resources, including personnel, to optimize the company's goals;

An important part of those controls is accurate information for internal decision making. A variety of information types is used for making critical business decisions. Proper internal controls help to avail information to management and hence enable effective decisions to be made. Effective decisions impact positively on the financial performance of a business.

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2.7 Relationship between a firm's age and internal control

According to Ge and McVay (2005) the experience of the firm in terms of its time duration in business has been found to be positively correlated to efficient and effective internal controls. Young firms have been found to have less efficient systems of internal control. This has been due to the fact that their main focus is to survive and to be able to make profit in the foreseeable future. As a result, there is less emphasis on designing and operating effective and efficient systems of internal control.

Ge and McVay further argue that small businesses have less elaborate accounting procedures, attach few values to ethical code of conducts, have inadequate separation of accounting duties and are unable to hire experienced staff to better their systems of internal control. Beasley et al. (2000) argues that older firms seem to have more effective and efficient internal controls. According to Beasley, as the firm continues to operate, employees become more experienced, and acquire more expertise through experience and formal training.

Similarly, Ge and McVay (2005) argue that as the firm grows the management becomes more sensitive to the system of internal control as the need to control the acquired assets becomes imperative. For example, as the firm experiences high inventory turnover, it becomes imperative to have an elaborate system of control to track the day-to-day

inventory transactions and ensure there is adequate supervision of both the incoming and outgoing inventories.

In addition, Kinney and Mcfraniel (1989) and Defond and Jiambalvo (1991) state that age is positively correlated with the growth of an enterprise' The more an enterprise grows the more an efficient and effective system of internal control is put in place. This is because as the firm grows, more assets are acquired and it becomes imperative for the firm to design and implement a more efficient and effective system of internal control to monitor the assets.

Defond and Jiambalvo further argue that as the firm grow, the proprietor finds it difficult to participate in all the day to day transactions of the business. ~his lack of participation in aJi the transactions of the business makes the proprietor to establish an efficient and effective system of internal centro I which will enable efficient and effective execution of transactions even in his absence.

Finally, Frankel et al. (2002) finds that older and bigger firms tend to have more resources to hire the services of internal auditors, business consultants and qualified and experienced personnel who can improve the system of internal control. In contrast, small and young firms may not have the resources at their disposal to warrant engagement of the services of auditors, business consultants and qualified and experienced personnel.

2.8 Relationship between availability of resources and internal control

Ge and McVay (2005) state that there is a positive relationship between the availability of resources in terms of personnel with accounting knowledge and an effective and efficient system of internal control. According to their empirical study on internal controls in small businesses, small businesses run on stringent budgets. Due to possession of inadequate funds there is an inadequate number of employees to run the enterprise. As a result, there is nc proper separation of duties and this puts the entries to a vulnerable situation espe: ially when an employee is assigned duties which can i enable the employee to

perpetrate a fraud and be able to conceal it. In addition, inadequate number of employees slows down the firm's operations and this impacts negatively on the financial performance of the firm.

Beasley et al. (2000) identified one major challenge which is caused by inadequate resources in the firm. Beasley argues that among the most common type of deficiency in internal control is in training and is often described as "having inadequate qualified staff". In this category of material weakness, most companies lack personnel with technical expertise in their various core duties. For example, lack of a financial reporting expertise is a serious material weakness that can lead to accounting errors and misstatements.

Similarly, Ge and McVay (2005) add that improper revenue recognition and inadequate separation of duties are pervasive material weaknesses in small businesses. For example, it is not wise to have one person authorize the payment of a vendor's invoice and also sign the cheque that pays the invoice. Ge and McVay argue that in addition to possible embezzlement, lack of separation of duties might facilitate financial statement manipulation.

Finally, good internal controls require both the financial resources and company time. This may not be a priority for firms which are mainly concerned with survival. Thus the ability to establish proper internal controls might vary with a firm's financial performance (Krishnan, 2005).

2.9 Internal controls in small businesses

According to Millichamp (1986), in a situation whereby a small enterprise is owned and run by the owner, the owner controls the business and this makes the formal controls of less importance to the small business. However, as the business begins to grow and employ more people, the need for internal control rises. Internal controls are particularly important in a small business when the owner does not participate in the day to day activities of the business.



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In evaluating the design of controls in small enterprises, the auditor may discover the inadequacy of a control. However, the weakness of this control may not be a threat to the business if the owner's review compensates for an otherwise lack of a control. For example, a small business may not have adequate separation of duties surrounding cash. Perhaps one person deposits the cash and reconciles the bank statements. However, if the owner diligently reviews the daily summary of cash receipts, as well as the bank statements and reconciliation, the owner's review compensates for an otherwise lack of a serious control (Aldridge and Colbert, 2004).

In addition, Doyle et al. (2005) adds that irrespective of the size of the business, the basic principles of a sound internal control system do not change. A small business may not be able to apply them as strictly or to the same extent as a large business but this in no way distracts from the principles the control is based on or the reason the controls are primarily needed to achieve a specific objective. In a small firm the owner should personally supervise or be directly involved with many of the checking functions described as being needed to ensure validity or accuracy in a transaction. In the case of cash receipt or payment the owner should be the sole authorizing manager for the daily banking or any cheque payment. The owner becomes the best internal control for safeguarding business assets.

2.9.1 Summary and conclusion

Literature on internal controls supports the fact that internal controls are perceived as a primary defense against fraud. Empirical studies conducted by the Association of Certified Fraud Examiners and various accounting firms have demonstrated the significant role played by effective internal controls in combating fraud.

Various authors seem to be in agreement that internal controls are equally applicable to both large and small businesses. These authors suggest that for an organization to have effective internal controls the five components of internal control should be designed and implemented. Literature also indicates that the COSO report (1992) should be used as the

benchmark when analyzing internal controls. The American Institute of Certified Public Accountants proposes that when evaluating internal controls one should focus on material weaknesses which results from one or two components of the internal controls not being able to reduce the chances of fraud occurring.

Some authors argue that small businesses do not have to ensure that all the five components of internal controls are operating. These authors argue that inadequacy of internal controls in small businesses can be compensated by the owner's diligent review of the day to day transactions of the business.

However, according to studies carried out in the US by the Association of Certified Fraud Examiners, small businesses maintain ineffective internal controls. This is largely attributed to scarce resources controlled by operators of small businesses. As a result of scarce resources, the operators of small businesses are unable to ensure adequate separation of duties and the creation of an internal audit department. Similarly, studies conducted in the US have shown that the system of internal control in place is influenced by the following variables: age of the enterprise, resources held by the enterprise and size of the enterprise.

This research will therefore seek to examine whether the findings in the Nairobi, Kenya concerning internal controls in small businesses will be similar to the findings in the US. In addition, this research will seek to examine whether the age of an enterprise and the number of accounting personnel influence the strength of a system of internal control. Finally, the researcher will seek to explore the relationship between the strength of a system of internal control and its influence to financial performance.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Research design

The research was quantitative because the researcher sought to quantify which components of internal controls were designed and maintained in the 30 enterprises surveyed. Secondly, the research was quantitative because the researcher sought to explain the nature of the relationship between the age of an enterprise and the number of internal control weaknesses. Thirdly, the researcher sought to explain the relationship between resources held by an enterprise and the internal control weaknesses. Resources held were measured mainly through the number of qualified accountants in the organization.

Finally, the researcher sought to explain and describe the degree of the relationship between the strength of a system of internal control and the financial performance of an enterprise. The financial performance was represented by annual profit figures. In evaluating the internal controls in small businesses, the researcher used the COSO report of 1992. The researcher structured the COSO report of 1992 to serve as an interview guide and a checklist to evaluate the efficiency and effectiveness of the systems of internal control. According to the COSO report, the guiding principle is: the lower the implementation of the various internal control components, the lower the efficiency and effectiveness of the system of internal control.

3.2 Population and sampling

The researcher's target population was small businesses operating in Nairobi. The researcher was guided by the National Social Security Fund (NSSF) register, 2008 of businesses. The researcher chose the NSSF register because it has conveniently classified the registered businesses into micro, small, medium and large enterprises. In addition, the NSSF register's definition of a small business is consistent with that of the World Bank.

According to the NSSF register there are 4,600 small enterprises registered in Nairobi. However, Nairobi is divided into five regions which include: the Central Business District (CBD), Eastern, Northern, Western, and Southern regions. According to the register, the CBD region is rated as the most active region. The criteria for deciding on what active meant was guided by the NSSF management which rated active enterprises according to how compliant the enterprise was with various rules and regulations set by the NSSF management, and participation of the enterprise in activities like seminars, workshops and forums organized by the NSSF management. The CBD had the highest number of active enterprises and hence was chosen for the purpose of this study. There are 1,400 small enterprises registered in the CBD. The researcher then sent the 50 most active enterprises within the CBD e-mails asking for a chance to interview their managers. 40 enterprises replied granting the researcher a chance to interview them. This represented a response rate of 80%. Of the 40 enterprises that accorded the researcher a chance to interview their managers, 10 enterprises refused to part with some information which included financial performance and information concerning fraud. Hence, 30 enterprises became the researcher's sample.

As stated earlier, the NSSF description of small businesses is consistent with that of the World Bank.

Businesses were screened to ensure that they fitted within the World Bank's definition of a small business before they were considered for inclusion in the sample population.

3.3 Data collection methods

The researcher collected data through the interview method. The Interview guide was prepared based on the COSO report of 1992 on what constitutes an effective and efficient system of internal control. Questions were posed to the small businesses' managers. In order for the researcher to gain a deeper understanding of the internal control systems in place, the researcher personally interviewed the business managers so that he could offer explanations in case of any difficulties in the subject area. The personal interview method also enabled the researcher to restructure the questions to fit the respondent's scope of knowledge in this subject.

Similarly, the interview method granted the researcher the opportunity to adopt the language of the interview to the educational level of the respondents. Through the interview method the researcher was also able to observe documents pertaining to internal controls.

3.4 Data analysis

In addressing the first objective of the study, the researcher used descriptive statistics: that is, data on the first objective was summarized and presented in the form of frequencies, percentages, bar graphs and pie charts.

Second, the researcher used Minitab to analyze the three relationships in question. In particular, the researcher used multiple regressions to analyze the relationship between the age of an enterprise, profitability, the number of accounting personnel and internal control weaknesses. In this relationship, the independent variables were age, profitability, and the number of accountants. The dependent variable was internal control system weaknesses. The researcher measured the number of internal control weaknesses by counting the number of components and subcomponents of internal control that were not implemented in an organization.

In the multiple regression analysis, the model was:

$$Y = C + B_1X_1 + B_2X_2 + B_3X_3$$

Where,

Y = the number of internal control weaknesses;

X_1 = the number of accounting personnel;

X_2 = profitability;

X_3 = age of the enterprise;

C = constant;

B_1 , B_2 and B_3 = the coefficients of X_1 , X_2 , and X_3 in the multiple regression equation.



CHAPTER FOUR

DATA ANALYSIS AND FINDINGS

4.1 Introduction

This chapter presents the analysis and the findings of the study based on the findings from the sample small businesses operating in Nairobi. This chapter is structured as follows: first, the researcher mentions the characteristics of the 30 small businesses surveyed.

Second, the researcher uses descriptive statistics to summarize the findings and answer the first research question.

Third, the researcher uses multiple regression analysis to provide answers to the second and third research questions. The fourth research question was answered through a simple regression analysis.

4.2 Sample Characteristics

The 30 small enterprises surveyed ranged from automobiles repair businesses, beauty service providers, building and construction businesses, cleaning service providers, cargo delivery service providers, clearing and forwarding businesses, education service providers, food processing firms, legal service providers, security service providers, tour operators, waste management businesses, furniture dealers, retail businesses, and agricultural firms.

Table 4.1: Number of Employees

	Frequency	Percent
11-20	16	53.3
21-30	5	16.7
31-40	3	10
41-50	6	20
Total	30	100

The researcher found out that the majority of the small businesses surveyed had a range of 11-20 employees as indicated by 53.3% of the respondents, 16.7% of the respondents reported that they had 21-30 employees, 20% of the respondents reported that they had 41-50 employees, while 10% of the respondents said that their business had 31-40 employees. These findings are summarized in the Table 4.1 in the previous page.

Table 4.1: Number of accountants

	Frequency	Percentage
Less than 3 f----	20	66
3 to 5	8	27
Over 5	2	7
Total	30	100

The researcher also sought to determine the number of accountants that the small businesses had employed at that particular time. As shown in Table 4.2 above, 66% of the sampled small businesses had fewer than 3 accountants, 27% of the small businesses had up to 5 accountants while only 7% have more than 5 accountants.

Table 4.2: Number of years in business

Period	Frequency	Percentage
Less than 3 years f-----	8	27
3 to 5 years 1-----	14	46
6 to 8 years f-----	8	27
Total f-----	30	100

The study also found that most of the small businesses surveyed had been in existence for a period of 3 to 5 years. The findings of this study indicate that no firm in the sample had been in business for more than 8 years. 27% of the small businesses have been in business for a period of less than 3 years, 46% of the small businesses have been in business for a period not exceeding 5 years while 27% of the small businesses have been in business for a period not exceeding 8 years. This is summarized in Table 4.3 in the previous page.

Table 4. 3: Annual Income

Scale	Frequency	Percentage
Up to 1 million	11	37
Up to 3 million	10	33
Up to 6 million	8	27
Above 6 million	1	3
Totall	30	100

The respondents were also asked to state what their range of annual profits was. As presented in Table 4.4 above, the study found that 37% of the businesses made up to Ksh 1 million in profit, 33 % of the small businesses reported up to Ksh 3 million while 27% of the small businesses reported up to Ksh 6 million. 3 % of small businesses surveyed had their annual profits surpassing Ksh 6 million.

Table 4. 4: Importance of Internal Controls

	Frequency	Percent
Very important	15	50
Important	9	30
Not important	6	20
Total	30	100

The respondents were also asked to state the extent to which they believed that internal controls were important. As shown in the table 4.5 above, 50 % of the respondents said that internal controls were very important, 30% of the respondents said that internal controls were important, and the remaining 20% of the respondents stated that internal controls were not important.

Table 4. 5: Hindrances to implementation of effective internal controls

	Frequency	Percentage
Lack of adequate resources	17	56.7
Lack of awareness	11	43.3
Total	30	100

The study also sought to investigate the factors that could have led to poor implementation of internal controls in small businesses. 56.7% of the respondents said that the implementation of internal controls in small businesses was hindered by lack of adequate resources. The remaining 43.3% of the respondents cited lack of awareness of what constitute an effective system of internal control as a hindrance to the implementation of an effective system of internal control. These results are also summarized table 4. 6 above.

It is important to point out that while thirteen respondents lacked awareness about internal control-they were not conversant with the five components of an effective system of internal control-they sometimes had policies in place in their businesses which were aspects of an effective internal control system. This becomes clear in the next paragraph.

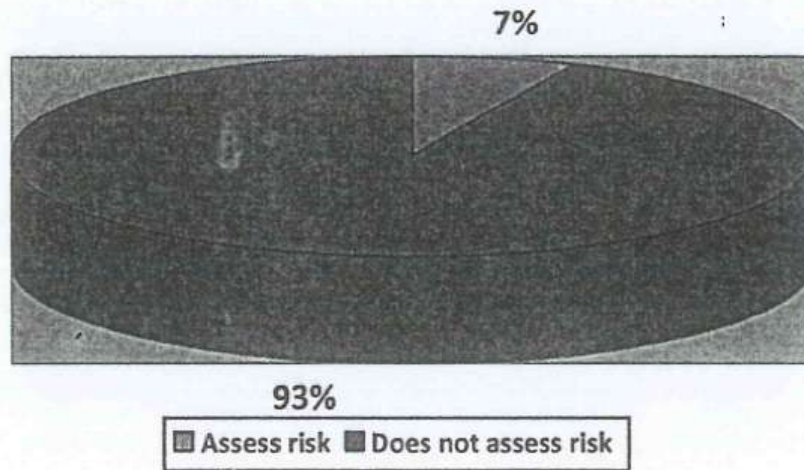
4.3 Existence of Internal Control Components

Table 4. 6: Control environment sub component

	Yes	No
Assignment of Authority	30 (100%)	0
Evaluation of employees policy	3 (10%)	27 (90%)
Human Resources policy	5 (17%)	25 (83%)
Management philosophy	25 (83%)	5 (17%)
Integrity and ethical values	16 (53%)	14 (47%)

The study also sought to quantify the level of implementation of the various components of internal control. First, the researcher evaluated the control environment component. 53% of the respondents had integrity and ethical policies in place; 83% of the respondents had management philosophies that emphasized on internal control; 17% of the respondents had human resource policies; 10% of the respondents engaged in evaluation of employee policies and 100% of the respondents had a system of assigning authority and responsibilities. These results are also shown in the table below .

Figure 1.1: Risk Assessment



The researcher asked the respondents whether they carry out continuous risk assessment. From the findings, it was clear that the majority of small businesses in Nairobi do not carry out continuous risk assessment. 93% of the respondents did not do so. However, a small proportion consisting of 7% of the respondents reported that they carry out continuous risk assessment. The figure above summarizes these results.

Table 4.8 control activities

Subcomponents	Yes	No
Adequate separation of duties	13 (43%)	17 (57%)
Proper authorization of transactions	28 (93%)	2 (7%)
Maintenance of documents and records	30 (100%)	0
Physical control over assets	18 (60%)	12 (40%)
Independent check on performance	27 (90%)	3 (10%)

The above table shows the results of the researcher seeking to investigate the control activities implemented by the organizations. The researcher found out that 43% of the respondents had enough staff to permit adequate separation of duties; 93% of the respondents had a mechanism to ensure proper authorization of transactions; 100% of the respondents ensured maintenance of documents and records; 60% of the respondents had a mechanism to ensure physical control over assets, while 90% of the respondents ensured independent checks on performance of duties assigned to them in a job description, then communicated to them in an informal ,rather than a formal ,manner.

Table 4. 7: Information Flow in the Organization

	Frequency	Percent
Top down	16	53
All directions	14	47
Total	30	100

The above table shows the results of the study seeking to investigate the information flow component in the organizations. The study established that in the majority of businesses, information flow was mainly top down. This is as indicated as indicated by 53% of the respondents. However, 47% of the respondents reported that the information flow in their businesses was in all directions.

Table 4.10: Means for relaying information

	Frequency	Percent
Telephone	13	43
Cell phone	6	20
E-mail	3	10
Not available	8	26
Total	30	100

The findings in the above table reveal that the majority of the small businesses in Nairobi have a designated communication protocol for employees to relay information to the management in case of any abnormal happening. 43% of the respondents said that telephone was their preferred mode of communication; 26% of the respondents said that there was no means available for their junior staff to relay information to the management; 20% of the respondents said that their junior staff used a cell phone to relay information to the management; another 20% of the respondents said that their junior staff used electronic mail to relay information to the management.

Table 4.11: Experience with Fraud

	Frequency	Percent
Yes	13	43
No	17	57
Total	30	100.0

The researcher also asked the respondents whether they have ever experienced fraud in their businesses. From the findings in the above table, 57% of the respondents said that they had never experienced fraud in their businesses while 43% of the respondents said that they have experienced it.

Table 4.12: Frequency of frauds

	Frequency	Percent
Once	9	69.2
Twice	4	30.8
Total	13	100.0

The respondents who reported that they had experienced fraud were requested to state how many times they had experienced it. 69.2% of the respondents said that they had experienced fraud once in their businesses, while 30.8% of the respondents reported that they had experienced fraud twice. No respondent indicated that they had experienced fraud more than twice.

Table 4.13: Understanding of Internal control system by affected personnel

	Frequency	Percent
Yes	10	33
No'	20	67
Total	30	100

Table 4.13 shows the number of respondents who did not understand the relevant aspects of the internal control system 67% of the respondents reported that their personnel who are affected by the internal control system did not understand the relevant aspects of the internal control system. 33% of the respondents said that their personnel who were affected by the internal control system understood the relevant aspect pertaining to it.

Table 4.14: Monitoring component of internal control

	Frequency	Percent
Yes	29	96.7
No	1	3.3
Total	30	100.0

The respondents were asked whether management monitors the internal control system in place. The researcher found out that 96.7% of the respondents engage in monitoring of the internal control system in place while 3.3% of the respondents do not monitor the system of internal control in place. This findings are supported by table 4.14 in the previous page.

Table 4.15: Forms of Monitoring

	Yes	NO
Training of personnel	15 (50%)	15 (50%)
Evaluation of personnel	4 (13.3%)	26 (86.7%)
supervision	29 (96.7%)	1 (3.3%)

The researcher requested the respondents to give the forms of monitoring that mainly occur in their organizations. The table 4.15 above shows that the majority of the organizations, supervision was the main form of monitoring. As indicated by 96.7% of the respondents, 50% of the respondents said that there was training of personnel on different accounting issues in their organizations. Finally, only 13.3% of the respondents engaged in evaluation of their personnel.

Table 4.16: Reconciliation of bank statements

	Frequency	Percentage
Accountants	21	70
Business owners	9	30
Total	30	100

The researcher also requested the respondents to state who had the responsibility of reconciling the books of accounts. From the findings, 70% of the respondents reported that the accountants did their bank reconciliation. 30% of the respondents said that the business owners reconciled the bank statements.

Table 4.17: Follow-up of daily transactions

	Frequency	Percent
Yes	27	90.0
No	3	10.0
Total	30	100.0

The above table shows the findings on whether the owner of the small businesses makes a follow up to ensure that the day-to-day transactions are correct. From the findings, the majority of respondents as shown by 90% of the respondents said that the owners of the small businesses made a follow up to ensure that the day to day transactions were correct, while a small proportion comprising of 10% of the respondents reported that the owners did not make a follow up on the day to day transactions of the business.

Table 4.18: suggestions for improving a system of internal control

	Frequency	Percentage
Not aware	21	70
Internal audit department	9	30
Total	30	100

The researcher also sought the opinion of the respondents on ways by which internal controls could be strengthened in small businesses. 70% of the respondents said that they were not aware of the means by which they could strengthen their system of internal controls while 30% of the respondents stated that they could strengthen their systems of internal control by installing internal audit departments in their organizations these results are also shown by the table above.

4.4 Relationship between the number of accounting personnel, profitability, and age verses internal control system weaknesses

Let Y the number of internal control weaknesses;

X the number of accounting personnel;

l profit in millions;

X the age of the enterprise in years; i

β_0 = constant;

$\beta_1, \beta_2, \beta_3$ = the coefficients of X1, X2 and X3 in the regression equation. Hence, $\beta_1 = -0.4138$, $\beta_2 = -0.09773$ and $\beta_3 = -0.4331$

The regression equation is:

$$Y = 8.6033 - 0.4138X_1 - 0.09773X_2 - 0.4331X_3$$

Table 4. 8: Regression results for internal control system weaknesses vs. accounting personnel, profit and age

Predictor	Coef	SE Coef	T	P
Constant	8.6033	0.5920	14.53	0.000
X1	-0.4138	0.2008	-2.06	0.049
X2	-0.09773	0.08142	-1.20	0.241
X3	-0.4331	0.2048	-2.11	0.044

$R^2 = 0.733$ $R^2_{adj} = 0.711$ %

PRESS=49.2104 $R^2_{pred} = 0.6104$ %

Table 4.9: Analysis of Variance (ANOVA)

source	DF	SS	MS	F	P
Regression	3	91.305	30.435	22.61	0.000
Residual error	26	34.995	1.346		
Total	29	126.300			

Durbin-Watson statistic 1.9895

A multiple regression analysis was performed as shown in the previous page to determine whether there is a relationship between the number of accounting personnel in an enterprise, profitability of the enterprise, age of the enterprise, and the strength of its system of internal control. The researcher also sought to quantify the degree of this relationship.

The researcher counted the number of material weaknesses reported in each particular enterprise. The higher the material weaknesses in the system of internal control the weaker the system of internal control. The dependent variable in the model was internal control system weaknesses while the independent variables were the number of accounting personnel, profitability and age.

From the model summary in the table in the previous page, the study found that there is a strong negative relationship between the number of accounting personnel and internal control weaknesses. Enterprises that disclosed high number of material weaknesses in their systems of internal control tended to have fewer number of accounting personnel and vice versa.

When the number of accounting personnel is increased by 1 the number of material weaknesses decrease by 0.4138

In addition, the study found that there is a weak negative relationship between profitability of an enterprise and internal control weaknesses.

When profitability is increased by 1 million the number of internal control weaknesses decreases by 0.0977. This indicates that enterprises that report higher profits tend to exhibit fewer material weaknesses in their systems of internal control.

Finally, the study established that there is a strong negative relationship between the age of an enterprise and its internal control system weaknesses. This finding is supported by the low P value of 0.044 in the regression analysis.

When the age of an enterprise is increased by 1 year, material weaknesses in the system of internal control decrease by 0.4331.

The R-Sq (adj) also shows that 71.1. 0% of the strength of internal control of an enterprise is determined by the number of accounting personnel, profitability, and age of an enterprise while 29.9% of internal control strength is determined by other factors.

The model is supported by a P value of zero. This indicates reliability of the regression model.

The Durbin-Watson statistic is 1.9895, this statistic which is very close to 2 also supports the validity of the regression model. The Durbin-Watson statistic measures the validity of a regression model in a scale of 0 and 4. Two denotes overwhelming evidence in support of the model.

CHAPTER FIVE

DISCUSSION AND CONCLUSION

5.1 Introduction

The primary purpose of this study was to evaluate the systems of internal controls maintained by operators of small businesses. This chapter aims at answering each research questions, examining and explaining any variations in the data, comparing the findings with prior research, recommendations for further research, limitation and conclusion.

5.2 Answering the research questions

The answers to the research questions were presented in chapter 4. However, further insights are provided below.

5.2.1 Question 1: What is the level of efficiency and effectiveness of the systems of internal control maintained by small businesses?

The researcher used descriptive statistics to answer this research question. The five components of internal control were evaluated. The researcher established that the level of efficiency and effectiveness of systems of internal control varied from one enterprise to the other. Of the five components of internal control, the risk assessment component, and the information and communication component were the components which were not implemented in most enterprises.

Only 7% of the respondents had implemented the risk analysis component of internal control. Similarly, only 47% of the respondents had implemented the proper flow of information component in their organizations.

The monitoring component of internal control was the mostly implemented component. 96.7% of the respondent had appropriately implemented the monitoring component in their enterprises.

In evaluating the control environment component, the researcher evaluated each of the subcomponent independently. The researcher established that 100% of the respondent had the assignment of authority and responsibility sub component in place, 10% of the respondents had evaluation of employees policies subcomponent in place, 17% of the respondents had human resources policies, 83% of the respondents had a defined management philosophy, and 53% of the respondents had integrity and ethical values in place.

In evaluating the control activity component of internal control, the researcher established that 57% of the respondents had no enough human resources to ensure adequate separation of duties. However, 93% of the respondents had proper policies to ensure proper authorization of transactions. 100% of the respondents had maintained their documents and records; in addition 60% of the respondents had a mechanism to ensure physical control over assets. Finally, 90% of the respondents ensured independent checks on performance.

5.2.2 Question 2: What is the nature of the relationship between the age of an enterprise and the effectiveness and efficiency of its system of internal control? Using multiple regression analysis, the researcher established that there is a strong negative relationship between the age of an enterprise and its internal control system weaknesses. When the age of an enterprise is increased by 1 Year, material weaknesses in the system of internal control decreased by 0.4331.

5.2.] Question 3: What is the nature of the relationship between the amount of resources held by an enterprise and the effectiveness and efficiency of its system of internal control?

The researcher established that there is a strong negative relationship between the number of accounting personnel and internal control weaknesses. Enterprises that disclosed higher level of material weaknesses in their systems of internal control tend to have fewer numbers of accounting personnel and vice versa. When the number of accounting

personnel is increased by I, the number of material weaknesses in the system of internal control decrease by 0.4138.

5.2.4 Question 4: To what extent does financial performance influence an enterprise's system of financial performance?

The research established that when profitability is increased by 1 million the number of internal control weaknesses decreases by 0.0977

5.3 Examining and explaining any variations in the data.

When exploring the four research questions in place, the researcher came across some particular variations in the data. These variations are highlighted below.

First, 20% of the enterprises which had been in business for only two years had a higher level of implementation of the various internal control components hence a higher efficiency and effectiveness of their systems of internal controls as compared to 26% of the enterprises which had a lower implementation of the various internal control component yet they had been in business for more than 5 years. This finding was contrary to literature which states that older firms have more efficient and effective systems of internal controls than younger firms.

Second, Out of the 13 enterprises who have had a problem with fraud, 3 of the cases had OCCURRED in enterprises that had a higher level of efficiency and effectiveness of internal controls, had been in business for more than 6 years, had at least 4 employees with accounting knowledge, and had reported superior financial results of up to KSH 6 million per year.

Third, 6.6% of the enterprises which reported a higher profit margin of up to 6 million per year had a lower level of implementation of the various internal control components as compared to 27% of the respondents who reported a profit margin of up to 3 Million yet they had a higher implementation of the various components of internal control.

5.4 Conclusion

The study was designed with four main objectives. The first objective was to examine whether small businesses keep effective and efficient internal controls. The second objective was to examine whether there is a relationship between the age of an enterprise and the effectiveness of its system of internal control. The third objective was to examine whether there is a relationship between the resources held by an enterprise and the effectiveness and efficiency of its system of internal control. The fourth and last objective was to examine whether the effectiveness and efficiency of a system of internal control influences an entity's financial performance.

To begin with, few respondents understood what the term internal control meant.

Understanding of internal control was equally low at the employee level.

With researches done in the 1 JS indicating that frauds are being detected more by alert employees than auditors, the low level of understanding of internal control by small business employees in Nairobi could hamper detection of fraud.

The risk analysis component is the most ignored component of internal control.

In addition, information flow in most small businesses is top down. With this kind of information flow it becomes difficult for an employee who has observed an abnormal behavior to report it to the management.

The researcher also disclosed material weaknesses in other components of internal control. However, the level and nature of the disclosed material weaknesses varied from one enterprise to another. This finding is consistent with that of Ge and Mcvay (2005) who established that the nature of material weaknesses varied from one enterprise to another, and that different industry segments tend to disclose different deficiencies in their systems of internal control.

The researcher established that there is significant statistical evidence to support the null hypothesis that older firms tend to have more efficient and effective internal control systems than younger firms. This finding is contrary to McMullen et al. (1996) whose

empirical findings show that there is little evidence to support that the disclosure of material weaknesses in a system of internal control is associated with a firm's age.

In addition, the researcher established that organizations that have more resources in terms of accounting personnel have fewer material weaknesses in their systems of internal control than organizations that wield fewer resources. This finding is consistent with Ge and Ma Yay (2005) who state that inadequate accounting resources underpin the majority of internal control weaknesses.

Finally, findings indicate that there is a weak negative relationship between internal control strength and financial performance of an enterprise. Enterprises with fewer weaknesses in their internal control system tend to report higher profit margins than enterprises with more material weaknesses in their systems of internal control. This finding is consistent with Bryan and Lillien (2005) who found that good financial performance is negatively related to internal control weaknesses.

5.5 Recommendations

With the low level of awareness of what constitutes an effective system of internal control, there is need to conduct seminars whose main focus is to enlighten employees with no accounting background on internal control and their responsibilities pertaining to internal control.

Since resources have been cited as a major hindrance to the implementation of effective systems of internal control, this setback can be offset by outsourcing the human resources function to organizations which specializes in screening, recruiting, setting up employee policies and evaluating employee performances. Outsourcing their human resources function will ensure that this aspect of internal control is implemented at a lower cost as compared to small businesses running their own human resources departments. Similarly, small businesses can improve on the implementation of the risk analysis component by hiring a Certified Public Accountant as a consultant on a timely basis to conduct this function. This will enable small businesses to implement this component of

internal control at a lower cost than running an audit department in the business.

Young firms with owners who have no prior background in accounting or with no prior experience in business should be encouraged form associations. i.e. association of small business owners.

This will enable new business owners to learn from the experience of older firms.

These associations should then provide forums touching on a wide range of issues among them should be internal control. This kind of forums will encourage pooling of resources that will enable small business owners to be able to hire the services of business consultants at a lower cost.

Finally, since majority of the respondents said that the accountants in their respective organizations reconciled their bank statements, owners of small businesses should ensure that these reconciliations are done by the accountants and approved by the owners of the businesses. Owners of small businesses should ensure that they subject the bank reconciliations to scrutiny to evade the chances of fraud from occurring. This will be particularly useful in small firms with only one accountant who handles all the receipts, payments and other accounting transactions.

5.6 Limitations of the study

The researcher had to contend with nasty remarks from some of the respondents.

For example, upon visiting a construction firm, these were the remarks that the researcher was welcomed with.

"You're wasting your time studying for a master's degree. Education is only useful at its most basic level, the higher you go the less useful it becomes. Some of the things that you people learn in school would better remain in books; they are not applicable in real life. I have a degree in civil engineering but how much of it do I put into Practice?"

Obtaining information on profitability of the businesses and whether the enterprise had suffered from fraud was very difficult. The researcher had to keep on reassuring the respondents that the information they divulged was only going to be used for the purpose of the study.

5.7 Suggestions for further research

With a fraud rate of 43% within the sample population, there is a need to investigate the nature of frauds occurring in small businesses, so that small business owners can be forewarned about the types of frauds to which they will be susceptible, and how they were detected; research needs to establish those detection methods and if they can be used by other business owners to discover whether fraud has occurred in their businesses.

In addition, this study could be replicated in medium and large enterprises to examine whether business enterprises that have graduated into medium and large enterprises still have material weaknesses in their internal control systems.

Furthermore, research needs to establish whether reporting frauds to the police results in any action being taken and whether the action was effective in having fraudsters prosecuted. Research may establish that business owners deal internally more effectively

with those frauds: what is done and how it is done can be established so that best practice in those circumstances can be derived

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APPENDICES

Appendix 1: Letter of Introduction

WILFRED KAKUCHA,
STRATHMORE UNIVERSITY,
P.O BOX 59857, 00200. NAIROBI.

Dear Sir/Madam,

RE: COLLECTION OF RESEARCH DATA.

I am a Master of Commerce student at Strathmore University. I am conducting research to examine the nature of internal controls in small businesses.

I hereby request to interview you for a duration of forty to fifty minutes concerning the status of internal control system in your business.

I promise that whatever information you will divulge to me will be treated with utmost confidentiality and will only be used for the purpose of the research. I also assure you that your business identity will not be disclosed.

Thank you for your cooperation.

Yours faithfully,

WILFRED KAKUCHA.

Signature of the supervisor,

JAMES BOYD MCFIE

Appendix 2: Interview Guide

1. Name of the business (fictitious)

2. What is the Total number of employees in this business?

.....

3. What is the total number of qualified accountants in this organization?

4. Number of years in business

5. Industry type

6. How important do you think internal controls are to small businesses?

Very

Important

Not important

important

7. What factors do you think hinders implementation of effective internal control systems?

(a) Lack of adequate resources (b)

Lack of awareness

(c) Others

8. Which among the components of the control environment has your business implemented?

(a) Emphasis on integrity and ethical values (b)

) Management philosophy

(c) Human resource policies

(d) Evaluation of employee policies

(e) Assignment of authority and responsibilities

9. Do you carry out continuous risk assessment to identify risks facing your business?

.....

10. Has your organization implemented any of the following control activities? (a)

Adequate separation of duties

(b) Ensure proper authorization of transactions

(c) Maintenance of documents and records

(d) Physical control over assets

(e) Independent check on performance

11. How would you describe the information flow in your organization?

Top down 1-----
Down up
Across 1-----
All directions 1-----

12. Does your organization have any designated means of communication for employees to relay information to the management in case they observe any abnormal activities?

.....

13. If yes, please state the designated means communication

.....

14. Has this organization ever experienced fraud?

.....

15. If yes, how many times?

.....

16. Do the personnel affected by your organization's internal control system clearly understand the relevant aspect of the internal control system and-their duties pertaining to the internal control system?

17. If yes, to what extent?

All employees	
Majority of employees	
A few employees	

18. Does the management monitor the internal control system to ensure that it remains effective?

19. If yes, how often?

... ,
.....
:....
.....
.

20. What form of monitoring mainly occurs in your organization?

Training of personnel	
Evaluation of personnel	
Supervision	

21. Does your organization keep proper books of accounts?

22. Who reconciles the books of accounts in your organization?

23. Does the owner make a follow up to ensure that reconciliations and other day to day transactions are correct?

24. If yes, how often does the owner diligently review the business transactions?

.....
.....
.....

25. Could you please suggest ways that you think that the system of internal control in this organization can be improved?

.....
..... ,
.....
..... ~
.....
.....

26. Could you please give me a range of your annual profits?

.....
.....
.....
.....

Thank you for your cooperation