

EFFECT OF INTERNAL CONTROL SYSTEMS ON FINANCIAL PERFORMANCE OF SMALL AND MEDIUM SCALE BUSINESS ENTERPRISES IN KISUMU CITY, KENYA

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ABSTRACT

There has been controversy as to why there is a declining business survival trend among Small and Medium scale Enterprises despite government's commitment to availability of funds. Economic Survey 2009 statistics indicate a tremendous growth of Small and Medium scale Enterprises in Kenya over the last ten years; constituting about 96 per cent of all business enterprises in the country; yet 90% of the business start-ups do not operate beyond their third anniversary. The main objective of this study therefore was to investigate the effect of internal control systems on financial performance among Small and Medium scale Enterprises in Kisumu city, Kenya; specifically assessing the relationship between internal control systems and return on investment; and establishing the level of business knowledge of an entrepreneur in internal control systems and its effect on financial performance. The sample was selected from the study population through stratified and simple random sampling techniques. The research was conducted using both quantitative and qualitative approaches; adapting cross-sectional survey research design. The study used both primary and secondary data. Primary data was collected using structured questionnaire and interview, while secondary data was obtained from financial statements of the sampled enterprises. Data was analyzed using descriptive statistics as well as inferential statistics. The study specifically revealed that a significant change in financial performance is linked to internal controls systems. Based on the findings of the study, it is concluded that internal control systems as supported by the study findings significantly influence the financial performance of Small and Medium scale Enterprises. The investigation recommends training on the significance of internal controls among proprietors of Small and Medium scale Enterprises.

Key Words: *Small and Medium Enterprises, Internal Control Systems, Financial Performance*

Introduction

This chapter focuses on the background to the study in which the concept of Internal Control Systems (ICSs) is put into perspective, as well as bringing out the general perception that; institution of systems of internal control will always lead to improved financial performance. The Chapter handles the purpose of the study which is establishing the relationship between ICSs and financial performance. It also concerns the specific objectives of the study that were determined as; determining the functionality of ICSs among Small and Medium scale Enterprises (SMEs) and examining the relationship between ICSs and financial performance of SMEs. Research hypotheses which are basically derived from the Research objectives clearly brought out the belief that; there is a relationship between Return on Investment (ROI) and ICSs among SMEs, the level of business knowledge of entrepreneurs in ICSs affect financial performance of SMEs, and there is a relationship between growth in profits among SMEs and the strength of ICSs. The chapter also brings into focus the scope of the study as covering Kisumu City, Kenya. It tackles the justification of the research and brings out a diagrammatical representation linking internal controls and financial performance.

Internal controls refer to the measures instituted by an organization so as to ensure attainment of the entity's objectives, goals and missions. They are a set of policies and procedures adopted by an entity in ensuring that an organization's transactions are processed in the appropriate manner to avoid waste, theft and misuse of organization resources. Internal Controls are processes designed and effected by those charged with governance, management, and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of the financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations (Mwindi, 2008). It is worth noting that internal controls only provide reasonable but not absolute assurance to an entity's management and board of directors that the organization's objectives will be achieved. "The likelihood of achievement is affected by limitations inherent in all systems of internal control" (Hayes et al., 2005). Organizations establish systems of internal control to help them achieve performance and organizational goals, prevent loss of resources, enable production of reliable reports and ensure compliance with laws and regulations. An internal control system comprises the whole network of systems established in an organization to provide reasonable assurance that organizational objectives will be achieved.

Benefits of an internal control system include effectiveness and efficiency of operations, reliability of financial reporting and compliance with applicable laws and regulations. The small and medium scale business enterprises form the informal sector which has been recognized not only to play a major role in Kenya's economy but also provide the much needed employment opportunities. Studies have shown that the sector has the necessary ability of alleviating poverty through the creation of employment opportunities and generation of income (Webster, 1991). In recognition of the steady increase in unemployment, the Kenyan government has appreciated the

role the small and medium scale enterprises are set to play. The Kenyan government has attempted to address this issue in sessional papers 1 and 2 of 1986 and 1992.

Within the business population, small and medium-sized businesses are the predominant form of business organization (Corbetta and Montemerlo 1999), a factor that has contributed to the urgent need for ICSs. They provide extensive contributions to Gross National Products (GNP), job generation and wealth creation (Kelly, Athanassiou and Crittenden, 2000). Nevertheless, in ICS, this form of business group is largely underrepresented (Steier, Chrisman and Chua, 2004).

SMEs have concentrated on the availability, accessibility and cost efficiency in the utilization of finances. Little attention has been paid to the great role played by the internal control systems in the performance of businesses. Small and medium scale enterprises have operated in total disregard of internal control systems leading to the mass failure of these business organizations (Lydia Were, 2011). Studies show that 90% of the business start-ups do not operate beyond the third anniversary due to lack of sound internal control systems (Katuntu, 2005). Therefore, the study sought to contribute to the existing literature by empirically investigating the role of internal control systems on financial performance and its importance in small and medium-sized enterprises.

Statement of the Research Problem

Kenya has about 1.6 million registered Small and Medium sized Enterprises constituting about 96 per cent of all business enterprises in the country (Economic Survey, 2009). SMEs represent the largest sector in the economy employing up to 75% Kenya's workforce and contributing up to 18.4% of the country's Gross Domestic Product (GDP) (Economic Survey, 2009). SMEs have expressed an impressive need to grow and introduced various expansion mechanisms. It is this realization that pushed the Nairobi Securities Exchange (NSE) to finally decide to open doors to this promising sector. It is for this reason that the Capital Markets Authority (CMA) in Kenya has announced that it intends to list small and medium enterprises in the NSE under a special market division with less stringent regulations for the small business. With these, comes growth, setting in complexities in running of SMEs, unless the issue of internal controls is addressed urgently. This study investigated the relationship between internal control systems and financial performance among the small and medium sized business enterprises.

Objective of the Study

The broad objective of this study was to investigate the relationship between internal control systems and financial performance among the small and medium sized business enterprises in Kisumu, Kenya.

Specific Objectives of the Study

1. To assess the relationship between internal control systems and return on investment among SMEs.
2. To establish the level of business knowledge of an entrepreneur in internal control systems and its effect on financial performance of small and medium business enterprises.
3. To assess the relationship between internal control systems and growth in profits among SMEs.

Research Hypotheses

- H_{a1} There is a relationship between return on investment and internal control system(s) among SMEs.
- H_{a2} The levels of business knowledge of entrepreneurs in internal control systems affect financial performance of small and medium business enterprises.
- H_{a3} There is a relationship between growth in profits among SMEs and the strength of internal control systems.

Literature Review

The theoretical basis for establishing a relationship between financial performance and internal control systems has been documented in various literatures. Internal control systems that have been confirmed to have a relationship with business organization financial performance include: organization, segregation of duties, physical authorization and approval, arithmetical and accounting, personnel, supervision, management, acknowledgement of performance and budgeting (Weber, 1998).

Anduuru (2005) points out the importance of internal control systems. He notes that the external auditors find it difficult to rely on internal control systems of small and medium scale enterprises. This is so because such business entities have not established elaborate systems of internal controls, there is no adequate segregation of duties and there are no assurances as to the completeness of recording business transactions. Ongoing monitoring activities of small entities are more likely to be informal and typically performed as part of the overall management of the entity's operations (Wamae, 2005). Management's close involvement in operations often will identify significant variances from expectations and inaccuracies in financial data leading to corrective action to the controls.

Wolf (1994) argues that basic concepts of the entity's risk assessment process are relevant to every entity, regardless of the size, but the risk assessment process is likely to be less structured in small entities than in larger, well established entities. Weber (1998) points out that small entities may implement the control environment elements differently than larger entities. Small entities might not have written codes of conduct. Moreover, those charged with governance in small entities may not include an independent or outside member. Small entities are less

committed to the advancement or hiring of qualified personnel to positions of responsibility in business entities.

Small scale enterprises are mostly managed by family members and close relatives who show less interest in following internal control systems they have to the latter. Internal controls are a function of internal audit function (Messier, 1997). Small entities have disregarded this important function whose benefits may prove to be more than the costs of having none. Messier (1997) points out that a firm's performance depends heavily on a sound internal audit function. Small and medium sized businesses are not too small for effective internal controls (Putra, 2011). Even a relatively small business can enforce certain internal controls that are very effective. To have a competitive edge over the rest of the firms, business entities constantly carry out appraisals of their internal control systems. Therefore, the basis of superior enterprise financial performance is stronger, reliable and up to date systems of internal controls.

Elements of Internal Control

Internal control systems operate at different levels of effectiveness. Determining whether a particular internal control system is effective is a judgement resulting from an assessment of whether the five components - Control Environment, Risk Assessment, Control Activities, Information and Communication, and Monitoring - are present and functioning. Effective controls provide reasonable assurance regarding the accomplishment of established objectives. For the purpose of this study, I will limit the components of ICS to three; control environment, control activities and monitoring of controls (Anduuru, 2005).

Control Environment

The control environment, as established by the organization's administration, sets the tone of an institution and influences the control consciousness of its people (Whittington and Pany, 2001). Management attitude should be committed to ethical business practices and to following the established control procedures. This is the foundation for all other components of internal control, providing discipline and structure. Control environment factors include: Integrity and ethical values; the commitment to competence; leadership philosophy and operating style; and the way management assigns authority and responsibility, and organizes and develops its people.

Control Activities

Control activities are the policies and procedures that help ensure management directives are carried out. They help ensure that necessary actions are taken to address risks to achievement of the entity's objectives. Control activities occur throughout the organization, at all levels, and in all functions. They include a range of activities as diverse as approvals, authorizations, verifications, reconciliations, reviews of operating performance, security of assets and segregation of duties. Control activities usually involve two elements: a policy establishing what should be done and procedures to effect the policy. All policies must be implemented thoughtfully, conscientiously and consistently (Anduuru, 2005).

Monitoring of Controls

Internal control systems need to be monitored - a process that assesses the quality of the system's performance over time. Ongoing monitoring occurs in the ordinary course of operations, and includes regular management and supervisory activities, and other actions personnel take in performing their duties that assess the quality of internal control system performance (Colbert & Bowen, 1996).

The scope and frequency of separate evaluations depend primarily on an assessment of risks and the effectiveness of ongoing monitoring procedures. Internal control deficiencies should be reported upstream, with serious matters reported immediately to top administration and governing boards. Internal control systems change over time. The way controls are applied may evolve once effective procedures can become less effective due to the arrival of new personnel, varying effectiveness of training and supervision, time and resources constraints, or additional pressures. Furthermore, circumstances for which the internal control system was originally designed also may change. Because of changing conditions, management needs to determine whether the internal control system continues to be relevant and able to address new risks (Roth, 1997).

Review of Empirical Studies on Internal Control Systems

As it has been mentioned before, internal control system is a critical component of an organization's management and a foundation for its safe and sound operations (Drogalas et al., 2005; Karagiorgos et al., 2010). Internal control comprises five components; the control environment, the entity's risk assessment process, the information and communication systems, control activities and the monitoring of controls (Hayes et al., 2005). However, for purposes of this study, the research narrowed down to only three components of the internal control system. These are; the control environment, monitoring of controls and control activities. The other components of the internal control systems were held constant.

There seem to be very little empirical literature on internal control systems for SMEs. However, various scholars and professionals in America and Europe have carried out studies on internal control systems for the larger corporations, the findings of which can be applied to SMEs. Companies with ICSs are observed to be significantly larger, more highly regulated, more competitive, more profitable, more liquid, more conservative in their accounting policies, more competent in their management and accounting, and subject to better management controls (Wallace & Kreutzfeldt, 1991). A study by Goodwin-Stewart & Kent (2006), using a sample of Australian listed companies, shows that the existence of an Internal Control System is positively associated with firm size and commitment to risk management.

The risk and control awareness have an influence on the scope of the ICS (Sarens & De Beelde, 2006). These results suggest that when management is aware of risks and control activities, they are more likely to understand the role of the ICS in monitoring risk and control activities, thus it is more likely that they will support a relatively larger ICS (Sarens & De Beelde, 2006; Selim &

McNamee, 1999). According to Kotler (1992), strong performing firms are those that can stay in business for a good number of years. Dwivedi (2002) also found out that, the ability of a firm to survive in business in an indicator of good financial performance. 38 active British businesses went into liquidation in the third quarter of 1992 and in 1991 a total of 21,827 businesses failed compared to 15,051 in 1990, majorly because of weak ICS (Richardson, Sonny & Suzan, 1994). However in Uganda, about 90% of Ugandan SMEs collapse within 3 years (Katuntu, 2005). Lack of or weak ICSs are therefore an indicator of poor financial performance.

Financial performance

According to Stoner (2003), performance refers to the ability to operate efficiently, profitability, survive grow and react to the environmental opportunities and threats. In agreement with this, Sollenberg & Anderson (1995) asserts that, performance is measured by how efficient the enterprise is in use of resources in achieving its objectives. It is the measure of attainment achieved by an individual, team, organization or process (EFQM, 1999). Hitt, et al (1996) believes that many firms' low performance is the result of poorly performing assets (businesses). Low performance from poorly performing assets is often related to strategic errors made in the acquisition process in earlier years. For example, some firms acquire businesses with unrealistic expectations of achieving synergy between the acquired assets and their current sets of assets. A common reason for such errors is managerial hubris (Roll, 1986) or overvaluation of managerial capability in the acquisition process.

Research Methodology

Research Design

The study was conducted using cross-sectional survey research design. Surveys are capable of obtaining information from large samples of the population. They are also well suited to gathering demographic data that describe the composition of the sample (McIntyre, 1999). Surveys are inclusive in the types and number of variables that can be studied, require minimal investment to develop and administer, and are relatively easy for making generalizations (Bell, 1996). However, surveys only provide estimates for the true population, not exact measurements (Salant & Dillman, 1994).

Study Area

The study was conducted in Kisumu city, which is the headquarter of the larger Kisumu County. Kisumu is a port city in western Kenya at 1,131 m (3,711 ft), with a population of 394,684 (2009 census). It is the third largest city in Kenya, the principal city of western Kenya, the immediate former capital of Nyanza Province. Kisumu is strategically located in the East African Community (EAC) and is likely to be the region's economic hub. Expansion of Kisumu International Airport, upgrading of road network in the region and creation of an enabling environment to restore investor confidence are some of the government initiatives towards fulfilling the goal of positioning Kisumu as an economic centre in the EAC region. Kisumu has a very well developed road transport connection with adjacent towns such as Kericho, Kakamega,

Homa-Bay, Kisii, Siaya, Busia and the sugar belt satellite townships of Muhoroni, Awasi, Chemelil, Miwani and Nandi Hills. Being on the convergence point of the Trans African Highway, Kisumu is well connected with Uganda and Tanzania and by extension Rwanda, Burundi and Congo DRC in the west, Zambia to the south and Sudan to the north. Its geographic position and its cosmopolitan profile, places Kisumu strategically as a competitive growth centre in the emergent age of technological and economic development.

Target Population

The population of the study constituted one hundred and sixty eight (168) SMEs in Kisumu registered with the Ministry of Labor, Kisumu office as at 31st December 2012. The study involved a cross section of businesses in different industries.

Sampling Frame

The study used stratified sampling, then convenience sampling was applied within each stratum. The population was stratified according to industry and then picked respondents by convenience sampling. Convenience sampling allows the researcher to select samples that are accessible and near (Saunders, 2003). The sampling procedure was based on a formula (Mugenda O.M. and Mugenda A.G., 2003).

$$\text{Sample Size} = n / [1 + (n/\text{population})]$$

Desired Sample Size (n)

$$n = z^2(pq/d^2)$$

Where:

n = the desired sample size.

z = Area under normal curve corresponding to the desired confidence level.

d = the level of statistical significance set (0.05).

p = a proportion in target population/expected compliance rate (0.50).

q = 1-p = 0.50

Therefore, desired sample size was as follows;

$$n = 1.96^2 \{ (0.50)(0.50)/0.05^2 \} = 384.16$$

Actual Sample Size (n_f)

$$n_f = n / \{ 1 + (n/N) \}$$

Where:

n_f = actual sample size.

n = desired sample size.

N = the estimated population size.

Given a target population of 168 business enterprises, the actual sample size (n_f) was;

$$n_f = 384 / \{ 1 + (384/168) \} = 117$$

Data Collection

Data collection is the process of gathering and measuring information on variables of interest, in an established systematic fashion that enables one to answer stated research questions, test hypotheses, and evaluate outcomes. The Researcher used a combination of structured questionnaires and interviews. According to Oso and Onen, (2008) questionnaires are a data collection technique in which the respondents respond to the number of items in writing. Questionnaires were chosen simply because of the time limitation. Interviews were the other data collection technique used by the Researcher. They were used as a way of supplementing the questionnaires already filled, but at the same time they would enable the Researcher probe further into the responses given in the questionnaires especially given the importance of the research and the specialized nature of the topic under study.

Data Presentation and Analysis

Research findings were presented through charts, graphs, tables and percentages. Data collected was fed into computer programs through the Statistical Package for Social Sciences (SPSS) for easy analysis and interpretation of results. The data was analyzed using both statistical and narrative methods. Correlation and regression analysis were used as a way of assessing the relationship between internal controls and business financial performance. Pearson's correlation was used to describe how the variables were related and the strengths of the relationships. Multiple regression model was used to determine whether the sets of independent variables together predict the dependent variable. The regression model was in the form:

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \varepsilon$$

Where;

- β_0 - Is the constant or intercept
- β_{1-3} - Are the regression coefficients or change induced in Y by each X
- X_1 - Independent variable effectiveness of internal controls
- X_2 - Independent variable review and verification of internal controls
- X_3 - Independent variable level of business knowledge of entrepreneur in internal controls
- Y - Dependent variable financial performance (Return on Investment)
- ε - Is the error component

Discussion of Research Findings

Background Information on SMEs

The background information of Small and Medium scale Enterprises was necessary because different business sectors or forms of ownership are likely to give varying feedback on the study variables. The background information of SMEs has been presented below categorized into; forms of business enterprise, and business area of operation.

Forms of Business Ownership

In table 4.1.1, it has been revealed that majority of SMEs are sole proprietorships, followed by companies, and finally partnerships in the orders of 57%, 37%, and 6% respectively. This clearly shows the dominance by sole proprietorships, controlling majority of the enterprises among SMEs. Unfortunately, this is the category that came out strongly as lacking effective ICSs.

Sector of Business Activity

The results revealed that majority of SMEs operate in other unspecified areas of operation, followed by retail, wholesale, transportation and hospitality, education and finally manufacturing, construction and health in the orders of 28.2%, 27.4%, 13.7%, 12.8%, 2.6% and 0.9% respectively. It is clear from the results that the retail sector dominates the Small and Medium scale Enterprises.

Respondent Characteristics

The background information of respondents was deemed necessary because the ability of the respondents to give satisfactory information on the study variables greatly depends on their background.

Education Characteristics of Respondents

The results of the survey suggest that majority of respondents hold diplomas, followed by technician certificate, KCSE certificate, and degree in the orders of 58%, 20%, 12%, and 10% respectively. This means that the respondents are adequately qualified persons academically. This increased the confidence in the technical information solicited from the SMEs. It also revealed that majority of SMEs have the human resource capacity that can be developed to implement ICSs.

Description of the Positions of Respondents

The results revealed that majority of SMEs directed and managed by proprietors, followed by finance managers and finally accountants, representing 50%, 27% and 23% respectively. From the description, it can be revealed that the majority of the respondents in this study are those directly responsible for or directly involved the implementation of the Internal Control System. Therefore, their responses are deemed to reflect what actually takes place in the business enterprise.

Respondents' Level of Knowledge in Internal Control Systems

The analysis results showed that majority of respondents in this study are very dissatisfied and satisfied with their level of knowledge on ICS, followed by very satisfied and dissatisfied respondents and finally averagely satisfied respondents. These represent 23%, 23%, 20%, 20% and 14% respectively. From the above description, it can be revealed that the majority of the respondents in this study are those satisfied with their level of knowledge on ICS, representing finance managers and accountants and those very dissatisfied, representing proprietors. The

results showed a mean of 2.97. This is above the mean average, implying that respondents agree as to their level of knowledge in ICS being sufficient. Nevertheless, the corresponding standard deviation of 1.468 suggests that respondents had a significant variation in responses on their level of knowledge in ICSs. However, this could also be construed to imply that respondents might not have clearly understood the dimensions of 'level of knowledge' in this context.

Internal Controls

Procedures Manual on Internal Controls

The analysis results showed that majority of SMEs in this study do not have a procedures manual on internal controls, representing 91% of the SMEs, leaving an insignificant 9% of SMEs with formalized manuals on internal controls. This confirms the researcher's fears that most SMEs show lack of commitment to ICSs. The results in this section are in tandem with Whittington and Pany (2001)'s assertion where they talk of the lack of commitment among SMEs in administering controls. This can also be likened to "the control environment setting the tone of the organization by influencing the control consciousness of people" stipulated by Cohen et al., (2002).

Internal Audit Department

The analysis results showed that majority of SMEs in this study do not have an internal audit department, representing 88% of the SMEs, with an insignificant 12% running ill-equipped internal audit departments. The analysis results further revealed that majority of SMEs in this study with internal audit departments do not conduct regular audit activities, representing 78.6% of the SMEs. This further confirms Whittington and Pany (2001)'s assertion where they talk of the lack of commitment among SMEs in administering controls.

Financial Statements External Audit

External audits strengthen systems of internal controls through regular reviews after every external audit as recommended by the management letters. Results revealed that a good number of SMEs in this study engage external auditors, representing 45.3% of the SMEs. It was further discovered through interviews that majority of the 45.3% engage external auditors for convenience purposes, when users of such externally audited financial statements demand so. This further casts doubts on the commitment towards strong ICSs.

Internal Control Systems and Financial Performance

Internal Controls and Return on Investment

Results revealed that a good number of respondents from SMEs in this study feel that the effectiveness of internal controls systems are average. It also reveals that respondents slightly agree on the effectiveness of internal controls as shown by a mean of 2.89. However a significant standard deviation of 1.297 is a clear manifestation of varied responses from respondents as far as effectiveness of internal controls is concerned. Findings showed a strong relationship between

effectiveness of internal controls and return on investment as revealed by a correlation coefficient of 0.893, with a standard error of 0.032. Specifically, effectiveness of internal controls relates positively with return on investment. This suggests that the effectiveness of internal controls relates positively with financial performance. The results seem to agree with Putra (2011)'s assertion of the effectiveness of internal controls setting the pace for organization's performance. This suggests that the effectiveness of internal controls is related with financial performance and therefore hypothesis one (Ha1); there is a relationship between return on investment and internal control system(s) among SMEs is accepted.

Level of Knowledge of Entrepreneur and Financial Performance

Results revealed a relationship between the level of knowledge of an entrepreneur and the business enterprise's financial performance. Findings show a strong relationship between level of knowledge in ICS and financial performance as revealed by correlation coefficients of 0.927, 0.974 and 0.988 for level of knowledge on ICS and growth rate in ROI, level of knowledge on ICS and growth rate in profits and level of knowledge on ICS and growth rate in revenue respectively. The associated standard errors on financial performance are 0.454, 0.314 and 0.223 respectively. Specifically, level of knowledge in ICS relates positively with return on investment, profits and revenue. This seems to agree with Ray and Pany (2001)'s belief that "knowledge of internal control systems help in improving financial performance". Since there is a positive relationship between the level of knowledge in ICS and the dimensions of financial performance; growth rate in ROI, growth rate in profits and growth rate in revenue, hypothesis two (Ha2); "the levels of business knowledge of entrepreneurs in internal control systems affect financial performance of small and medium business enterprises" is accepted.

Internal Control Systems and Profitability

Results revealed that respondents felt that there is a strong relationship between effectiveness of internal controls and growth in profits at a correlation coefficient of 0.936. It also reveals that respondents averagely agree on the effectiveness of internal controls as shown by a mean of 2.89. However a significant standard deviation of 1.297 is a clear manifestation of varied responses from respondents as far as effectiveness of internal controls is concerned.

The analysis results showed a correlation coefficient of 0.575, indicating a weak relationship between adherence to authorization procedures and growth in profits. However, the study reveals that respondents agree on the effectiveness of internal controls as shown by a mean of 3.07. A significant standard deviation of 1.207 is an indication of varied responses from respondents as far as adherence to authorization procedures is concerned.

Findings revealed that there exist a strong relationship between review and verification of internal controls and growth in profits at a correlation coefficient of 0.927. It also reveals that respondents averagely agree on the review and verification of internal controls as shown by a mean of 2.87. However a significant standard deviation of 1.267 is a clear indication of varied responses from respondents as far as review and verification of internal controls is concerned.

Therefore, the dimensions of internal control systems; effectiveness of internal controls, adherence to authorization procedures and review and verification of internal controls affect financial performance, thus hypothesis three (Ha3), There is a relationship between growth in profits among SMEs and the strength of internal control systems is accepted.

Summary of Findings

Internal Controls and Return on Investment

The study found out that majority of SMEs does not financial procedure manuals, especially one on internal control systems. The study also reveals that majority of SMEs do not have an internal audit department and the few that have, the departments are ill-equipped with inadequately trained personnel as well as inadequate financial resources. Consequently, conducting irregular audit activities without regular audit reports. They however, agree that the few reports that are produced in the department address the weaknesses in the system. It was further revealed that a good number of SMEs in the study engaged external auditors, though for convenience purposes, when users of such externally audited financial statements such as financial institutions demand so, casting doubts on the commitment towards strong internal control systems. On the effectiveness of the internal control systems, the study found out that the efficient internal controls positively influence financial performance.

Level of Knowledge of Entrepreneur and Financial Performance

The study examined and established a significant relationship between the levels of business knowledge of entrepreneurs in internal control systems and financial performance of small and medium business enterprises. This relationship was examined through the dimensions of financial performance and that of the level of business knowledge of entrepreneurs in internal control systems. It was revealed that the level of knowledge in internal control systems significantly influence the growth in proprietors' wealth. This statement is equally true for the improvement in the SMEs profitability.

The study found out too that there is a significant relationship between the level of knowledge on ICS and growth rate in revenue. Details show that level of business knowledge of entrepreneurs in internal control systems is linked to ROI ($r = 0.927$), level of business knowledge of entrepreneurs in internal control systems is also linked to profitability ($r = 0.974$), and level of business knowledge of entrepreneurs in internal control systems is related with revenue ($r = 0.988$). Specifically, level of knowledge of entrepreneurs in ICS relates positively with return on investment, profits and revenue.

Internal Control Systems and Profitability

The study investigated and established a significant relationship between internal control systems and profitability. This relationship was examined through the dimensions of internal control systems and that of the financial performance selected for this particular study. The dimensions of internal control systems (effectiveness of internal controls, adherence to authorization

procedures and review and verification of internal controls) were linked to the dimension of financial performance (profitability). Details show that effectiveness of internal controls is linked to profitability ($r = 0.936$), adherence to authorization procedures is also linked to profitability ($r = 0.545$), and review and verification of internal controls is related with profitability ($r = 0.927$). Therefore, the dimensions of internal control systems; effectiveness of internal controls, adherence to authorization procedures and review and verification of internal controls positively affect financial performance.

Conclusions

Based on the findings of the study, it is concluded that internal control systems as supported by the study findings significantly influence the financial performance of SMEs. However, there are challenges in the implementation of internal controls especially considering that the internal audit function which is the backbone of internal controls is not adequately equipped by the technical manpower required, which clearly has affected their efficiency as revealed by this study. Inadequate financial resources have also accelerated to their inefficiency, reflected by irregular audit activities as well as absence of regular reports.

On the levels of business knowledge of entrepreneurs in internal control systems, proprietors were very dissatisfied with their competence and yet they happen to be at the helm of most SMEs. Therefore the study concludes that the business knowledge of entrepreneurs in ICSs is not appropriate, even though the study reveals an improvement in financial performance vis-à-vis knowledge in ICSs. However, there do not seem to be significant relationship between adherence to authorization procedures and financial performance, as one of the dimensions of internal controls.

The final conclusion of this study is that there is a significant positive relationship between internal control system and financial performance.

Recommendations

Since it was evident in the study, that the appropriate staffing level in the internal audit department is not adequate to cover all aspects of internal controls, evidenced by not conducting regular audit activities, not operating efficiently as well as their reports not being regular, the study therefore recommends priority budgeting for this important department to enable SMEs realize the enormous benefits from this function.

The study also recommends regular audit reports, as well as regular review reports on functionality of internal controls so as to address the current business environment.

Finally, the study recommends that there should be a deliberate attempt to educate proprietors on the significance of business knowledge in internal control systems.

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